82-236

No.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUIS STERNBACH & COMPANY,

Petitioner,

- against -

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, on behalf of themselves and all others similarly situated,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether the common law doctrine of *respondeat superior* is an implied remedy available in private Causes of Action commenced under Section 10(b) of the Securities Exchange Act of 1934?

2. Whether the element of *scienter* can be established as against an alleged "aider-abettor" of violations of Section 10(b) of the Securities Exchange Act of 1934 on the basis of reckless behavior?

3. Whether an accountant's fraudulent intent can be inferred under Section 10(b) of the Securities Exchange Act of 1934 solely on the basis of claimed inadequate performance of auditing procedures and tests?

THE PARTIES

Petitioner Louis Sternbach & Company ["Sternbach"] was one of the named Defendants in the United States District Court for the Southern District of New York, and was later a Cross-Appellee in the appeal to the Second Circuit Court of Appeals.

Solitron Devices, Inc. ["Solitron"], and certain of its individual officers, including Messrs. Benjamin Friedman, James S. Trager, and James P. Barry, were Defendants in the District Court, and Appellants-Cross-Appellees in the Court of Appeals.[1]

Respondents Howard Sirota and Family Restorations, a Partnership, on behalf of themselves and all others similarly situated, were Plaintiffs in the District Court, and Appellees-Cross-Appellants in the Court of Appeals.

The claims of the class which Plaintiffs Robert J. Berk and Bruce M. Umlas purported to represent were dismissed by the District Court, and that dismissal was affirmed by the Second Circuit Court of Appeals.

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1. Solitron and its individual officers have also filed a Petition for a Writ of Certiorari [No. 81-2367]. The questions presented for review by Solitron and its officers are applicable to, and thus adopted by, Sternbach.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

OPINIONS BELOW

The opinion of the United States Court of Appeals, rendered February 19, 1982, is reported at 673 F.2d 566 (2d Cir. 1982), and is reproduced in the Appendix at A44.[2] The Court of Appeals opinion reversed the District Court's granting of Petitioner's motion for judgment notwithstanding the verdict. The unreported District Court opinion, rendered March 6, 1981, granting Petitioner judgment n.o.v., is reproduced in the Appendix at A1.

The Court of Appeals order denying the Petitions for Rehearing is reproduced in the Appendix at A67. The Court of Appeals order amending its opinion is reproduced in the Appendix at A69.

The Special Interrogatories submitted to and answered affirmatively by the jury as part of its verdict in the District Court are reproduced in the Appendix at A71.

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2. Page references to the Appendix to this Petition are cited as "A ."

JURISDICTION

The judgment of the Court of Appeals was set forth in its opinion rendered February 19, 1982. (A44) A timely Petition for Rehearing was filed by the Petitioner, and denied in an order filed May 13, 1982. (A67) This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

This Petition involves the interpretation and application of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), which provides as follows:

> "§ 78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • •
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The Petition also involves the interpretation and application of Securities and Exchange Commission Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, which provides as follows:

> "§ 240.10b-5 *Employment of manipulative and deceptive devices.*
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchaser or sale of any security."

STATEMENT OF THE CASE

In 1975, the Respondents commenced this action alleging that Solitron, and certain of its officers, including Messrs. Benjamin Friedman, James S. Trager, and James P. Barry, violated Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 promulgated thereunder. The Petitioner Sternbach, Solitron's independent outside accountants, was alleged to have "aided and abetted" the primary Section 10(b) violations of Solitron and its officers.

Respondents, later certified as a class of purchasers of the shares of common stock of Solitron, alleged that Solitron and its officers, "aided and abetted" by Sternbach, intentionally overstated Solitron's profitability in certain annual Financial Statements. Respondents claimed that Solitron's false and misleading Financials "polluted" the market, and thereby induced Respondents to purchase Solitron's stock at an artificially high price.

A jury returned a verdict in Respondents' favor based upon Special Interrogatories [A71] submitted to them. The jury found Solitron and its officers Friedman, Trager and Barry liable under Section 10(b) for intentionally participating in the publication and dissemination of false and misleading Financial Statements for years 1967, 1968, 1970, and 1972-1974. Sternbach was also found liable as a Section 10(b) "aider-abettor" for years 1967, 1968 and 1970 only, and also found liable for the same years in common law negligence. Sternbach resigned as Solitron's auditor commencing the 1972 fiscal year, and thus could not be held responsible for subsequent periods.

Respondents' proof at trial with respect to Sternbach was primarily premised upon claims that Sternbach had constructive, but not actual, knowledge of Solitron's overstatements of its inventory and sales in the years 1967, 1968 and 1970. Respondents' proof consisted of two reports prepared by the successor accountants Messrs. Price Waterhouse & Company.

The Price Waterhouse reports were prepared at Solitron's behest for use by Solitron in its defense of a claim made by the Eastern Regional Branch of the United States Renegotiation Board. In 1972 the Board had determined that Solitron had earned "excess profits" on its contracts with the federal government during the years 1967 and 1968. Solitron was therefore ordered to disgorge $7,600,000 of "excess profits" to the government. The reports submitted to the Renegotiation Board claimed that Solitron had not been as profitable in the 1967-1970 period as it had originally reported in its Financials and S.E.C. filings, and accordingly, had not earned "excess profits" as claimed by the government.

The Price Waterhouse reports were neither audited nor certified. The conclusions therein were later explicitly rejected by the Renegotiation Board. The Board refused to reconsider its original determination that Solitron had in fact earned "excess profits."[3]

Sternbach's defense at trial was that the Solitron Financials did not contain material misrepresentations, but if there were inaccuracies as alleged by Solitron before the Renegotiation Board, Sternbach was neither actually nor constructively aware of same.

Subsequent to the adverse jury verdict, Sternbach, and Solitron and its officers, moved for judgment notwithstanding the verdict. The motion submitted by Solitron, Friedman, Trager and Barry insofar as it related to 1972-1974 was granted, but denied for

3. Price Waterhouse stated in its report: "We are unable to determine the correctness of the quantities, costs or yield percentages included in the inventory summaries or worksheets for the five fiscal years ended February 28, 1970 or the authenticity of the worksheets and summaries provided us. Accordingly, we express no opinion in the inventory quantities, costs, yield percentages or valuations for the five fiscal years".

years 1967, 1968 and 1970. Sternbach's motion was granted in its entirety on both the Section 10(b) "aider-abettor" and negligence claims, for years 1967, 1968 and 1970.

With respect to the Section 10(b) claim against Sternbach, District Court Judge Charles L. Brieant, Jr. found that there was, "overwhelming uncontroverted evidence in favor of the defendant Sternbach. There was no evidence from which a reasonable juror acting reasonably could have concluded that Sternbach aided and abetted the primary securities law violation with the requisite *scienter*."[4] [A29-30] The common law negligence claim was dismissed as a matter of law, and later withdrawn by the Respondents on the appeal to the Second Circuit.

Thereafter, the Second Circuit reversed the granting of judgment n.o.v. to Sternbach, and affirmed-that part of the District Court decision pertaining to Solitron, Friedman, Trager and Barry.

The Circuit Court decision that concluded that Sternbach was liable as an "aider-abettor" of Solitron's primary Section 10(b) violations based its reasoning on a "combination" of three "facts":

> "Recalling the stringent standard for granting judgment notwithstanding the verdict, we disagree with the court's conclusion that no reasonable juror could have reached a verdict against Sternbach. First, the court's conclusion that Sternbach lacked actual knowledge is inconsistent with the jury's finding, upheld by the court on Defendant's post-trial motion, that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud. Second, evaluation of Cole's credibility, in the face of evidence suggesting he was on notice that the transactions he certified as sales were consignments, was for the jury, not the court. And in light of Sternbach's claim to have performed various costing procedures and tests on Solitron's 1967-70 inventory, the jury might well have concluded that Sternbach knew that its

4. The District Court's instructions to the jury charged that actual intent to defraud—not recklessness—was the appropriate standard of *scienter* for an alleged "aider-abettor" of Section 10(b) violations [A27-28, 57].

> certification of reports overstating inventory was fraudulent. The combination of these facts leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach had actual knowledge of fraud in violation of Rule 10b-5. [A59-60]

The Circuit Court's "combination" of "facts" analysis was materially mistaken both in fact[5] and law. The Circuit Court's first so-called "fact", that Sternbach could be held vicariously liable based on co-Petitioner James Trager's "knowledge of the fraud", is erroneous. The other erroneous "fact" recited by the Court was that the jury was permitted to infer that Sternbach possessed an intent to defraud by virtue of its performance of certain audit tests and procedures.

With respect to the first so-called "fact", Respondents never alleged that Sternbach's liability could be vicariously premised on Trager's conduct. That is because although James Trager was employed at Sternbach in 1967, 1968 and early 1969—prior to his employment at Solitron—Trager, contrary to the Court of Appeals opinion, was *not* "a former Sternbach accountant" [A39]. Trager testified that he was a part-time member of Sternbach's lower-echelon staff whose principle function was to count Solitron's inventory and mail confirmations. He was not a certified public accountant, lacked any college or graduate degree, and had completed only two years of college. He described himself as the "lowest fellow on the rung". [A76-79] There was no evidence to the contrary. Accordingly, Trager's primary 10(b) violations could not have been vicariously imputed

5. While it is axiomatic that this Court reviews questions of law, not fact, where, as here, a federal Court of Appeals has predicated its decision upon an egregious and material mistake of fact, as discussed *infra*, this Court can and should correct the error. See, *e.g.*, *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), where the Court reversed the Seventh Circuit's granting of summary judgment to the Plaintiff. In that case, Plaintiff alleged that the Defendant TSC Industries Inc. had participated in the issuance of a false and misleading proxy statement omitting material facts. In reversing, this Court recognized that the question before it was a "mixed question of law and fact" and held that none of the claimed omissions were, "so far as the record reveals, materially misleading as a matter of law" [*Id.*, 426 U.S. at 445-446].

to Sternbach as a matter of law. The common law doctrine of *respondent superior* is not an implied remedy available in private Section 10(b) Causes of Action.

The Court of Appeals further erred in its first so-called "fact" when it stated that Sternbach should be regarded as possessing an intent to defraud because of "the jury's finding . . . that Trager . . . had actual knowledge of the fraud" [A60]. The jury did not so find. Special Interrogatory "3", submitted to and answered affirmatively by the jury as part of its verdict, asked whether Trager "participated in the preparation and dissemination of [the Financial Statements] to the public with actual knowledge of their falsity or misleading nature *or with a reckless disregard of their truth or falsity*" [Emphasis Added][6] [A72-73]. Thus, even assuming *arguendo* that Trager's *scienter* could have been imputed to Sternbach, an actual intent to defraud standard of *scienter* could not have been imputed. The jury found that Trager either intended to defraud, or, acted recklessly. In this circumstance, the Court of Appeals erred when it decided not to reach the question of whether acutal intent to defraud or reckless conduct satisfied the proper standard of *scienter* as respects an alleged Section 10(b) "aider-abettor". [A59] As demonstrated *infra*, the Court of Appeals should have determined that only the standard of actual intent to defraud, not recklessness, satisfied the *scienter* requirement of Section 10(b) "aider-abettor" liability, and in the absence of a jury finding that Trager intended to defraud, Sternbach should not have been found vicariously liable.

The Court of Appeals also erred in the third so-called "fact" of its "combination" analysis when it held that the jury was allowed to have "concluded" that Sternbach possessed an actual intent to

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6. When reviewing a District Court judgment, the Court of Appeals is obliged to synthesize the District Judge's instructions and the jury's special findings so as to support the judgment. The failure to do so "results in a collision with the seventh amendment." *Atlantic & Gulf Stevedores, Inc.* v. *Ellerman Lines, Ltd.*, 369 U.S. 355, 364 (1962). The Seventh Amendment provides that "no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law".

defraud because of "Sternbach's claim to have performed various costing procedures and tests in Solitron's 1967-70 inventory". [A60] An accountant's performance of routine and ordinary auditing tests and procedures cannot, standing alone, permit a jury to infer an intent to defraud.

REASONS FOR GRANTING THE WRIT

I

THE COURT OF APPEALS ERRED WHEN IT HELD THAT THE COMMON LAW DOCTRINE OF *RESPONDEAT SUPERIOR* IS AN IMPLIED REMEDY IN PRIVATE CAUSES OF ACTION COMMENCED UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934.

In holding that the Sternbach partnership was liable under the federal securities law based on the acts of Trager, the Court of Appeals applied and extended the common law doctrine of *respondeat superior* in a manner never envisioned by either Congress or the Courts.[7] The Second Circuit's decision below irreconcilably conflicted with existing judicial authorities and should therefore be reversed insofar as it related to the Petitioner Sternbach.

The Court has never decided the issue of whether the doctrine of *respondeat superior* is an implied private remedy available for imputing Section 10(b) "aiding-abetting" liability. Recent decisions of this Court have severely restricted the availability of implied remedies under the federal securities law.

In *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979), this Court refused to recognize that Section 17(a) of the Securities Exchange Act of 1934 [15 U.S.C. § 78q(a)], which requires broker-dealers and others to prepare and file such records as the Securities and Exchange Commission may prescribe, created a private Cause of Action.

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7. See, generally, Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934," 69 *California Law Review* 80 (1981).

This Court charaterized as "entirely misplaced"[8] arguments that general tort law principles should justify a Section 17(a) implied right of action. Rather, this Court stated that the "central inquiry" is "whether Congress intended to create, either expressly or by implication, a private cause of action."[9] In the absence of statutory language indicating Congressional intent to create a Section 17(a) private remedy, none was implied.[10]

Further reasoning for the *Touche Ross* decision is found in the maxim *expressio unius est exclusio alterius*. The *Touche Ross* Court further reasoned that in view of the fact that Section 17(a) is found amidst other provisions of the Securities Exchange Act which do expressly grant private Causes of Action, the existence of these express remedies dictated against implication.[11] This Court observed that a Section 17(a) implied private remedy would necessarily conflict with the express private remedy of

8. 442 U.S. at 568.

9. *Id.* at 575. In holding that the foremost factor in determining the existence of an implied remedy is Congressional intent, and not the application of tort law, this Court rejected its earlier rationale expressed in *Texas & P.Ry. Co.* v. *Rigsby*, 241 U.S. 33 (1916). In a similar vein, *Touche Ross* also narrowed the holdings of *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), and *Cort* v. *Ash*, 422 U.S. 66 (1975). In *Borak* and *Cort*, this Court held that a private right of action could be inferred to effectuate the remedial intent of a statute even where no Congressional intent to create such a private right could be found.

10. The Plaintiffs in *Touche Ross*, as in the case at bar, alleged that accountants had certified as accurate a false and misleading financial statement. The accounting firm of Touche Ross & Co. was alleged to have certified the false and misleading financial statement of Weiss Securities, Inc., a securities brokerage house registered with the S.E.C. The financial statement, filed with the S.E.C. pursuant to Section 17(a), failed to disclose the alleged scheme of Weis's officers to conceal Weis's deteriorating financial condition. After Weis went into liquidation, and Redington was appointed trustee, the trustee sued Touche Ross on behalf of Weis's customers, alleging violations of Section 17(a). In the absence of statutory language in Section 17(a) that expressly creates a private remedy against accountants for certifying inaccurate financial statements, this Court reversed the Second Circuit's holding that Section 17(a) somehow established such a private remedy.

11. This Court cited its rationale in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 734 (1975): "When Congress wished to provide a damage remedy, it knew how to do so and did so expressly." 442 U.S. at 572. The Court referred to this as the rule of *expressio unius est exclusio alterius*. The expression of one thing is the exclusion of the other.

Section 18(a) [15 U.S.C. § 78r(a)], which creates a private action against persons who make materially misleading statements in reports filed with the S.E.C. The express remedy of Section 18(a) is limited to persons who, in reliance on the statements, purchased or sold securities at a price influenced by the statements. However, the Section 17(a) implied right of action suggested by the Plaintiffs in *Touche Ross* did not contain the allegation that Plaintiffs had relied on Touche Ross's certification when purchasing and selling securities. Hence, this Court concluded:

> "[W]here the principal express civil remedy for misstatements in reports [Section 18] . . . is by its terms limited to purchasers and sellers of securities, we are extremely reluctant to imply a cause of action in § 17(a) that is significantly broader than the remedy that Congress chose to provide." 442 U.S. at 574.

In *Transamerica Mortgage Advisors* v. *Lewis*, 444 U.S. 1 (1979), this Court again declined to imply a private right of action out of an existing federal regulatory statute. This Court adhered to its reasoning in *Touche Ross* when it held, that in the absence of express Congressional intent to create a private action for damages in Section 201 of the Investment Advisers Act of 1940 [15 U.S.C. §§ 80b-1-80b-21], no private action would be implied. As in *Touche Ross*, the *Transamerica* Court based its decision on the *expressio unius* rule[12], the language of the statute, and the absence of legislative history to the contrary.[13]

Touche Ross and *Transamerica* are consistent with the line of this Court's decisions that have narrowly interpreted and applied

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12. With respect to the *expressio* rule, this Court explained that in light of the express remedies of enforcement provided for in Section 206 of the Investment Advisers Act, Congress could not have "absentmindedly forgot to mention an intended private action." 444 U.S. at 15.

13. *Touche Ross* and *Transamerica* are consistent with other recent Supreme Court cases narrowing the availability of implied rights of action. *See, e.g. National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U.S. 453 (1974); *Securities Investor Protection Corp.* v. *Barbour*, 421 U.S. 212 (1975); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S.1 (1977).

Section 10(b). This Court has emphasized that in determining whether a Complaint stated a viable Cause of Action under Section 10(b), it was necessary to "turn first to the language of § 10(b)", for "[t]he starting point in every case involving construction of a statute is the language itself."[14]

In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), this Court held that an attempt to purchase or sell a "security" did not satisfy the requirement of the explicit language of Section 10(b) that the complained-of activity be "in connection with the purchase or sale of any security."

In *Ernst & Ernst* v. *Hochfelder, supra*, this Court held that evidence of negligent conduct would not suffice to state a Section 10(b) Cause of Action. This Court focused on the language of Section 10(b), which prohibits, "any manipulative or deceptive practice." These words, said this Court, "make unmistakable a Congressional intent to proscribe a type of conduct quite different from negligence."[15] A Section 10(b) Cause of Action, held this Court, required a showing of *scienter*, defined as, "a mental state embracing intent to deceive, manipulate, or defraud."[16] The question of whether reckless conduct can constitute *scienter* was reserved.

This Court's emphasis on the statutory language of Section 10(b) was again evident in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977). This Court refused to recognize an actionable claim under Section 10(b) for alleged breaches of "fiduciary duty" in connection with a corporate merger. This Court held that absent manipulation or deception, Section 10(b) did not reach breaches of "fiduciary duty."

It is apparent, then, that based on recent decisions of this Court, an implied private remedy of *respondeat superior* cannot be found to exist in Section 10(b).

There is no language in Section 10(b) from which one could reasonably imply the *respondeat superior* doctrine. Nor is there any evidence of Congressional intent suggesting such a reading.

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14. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976).
15. *Id.* at 199.
16. *Id.* at 193 n.12.

To the contrary, the *expressio unius* rule suggests that Congress did not intend to confer Section 10(b) with the attributes of vicarious liability. Section 20(a) of the Securities Exchange Act of 1934 [15 U.S.C. § 78t(a)], and Section 15 of the Securities Act of 1933 [15 U.S.C. § 77o] each provide that a "controlling person" may be liable for the securities violations of others. Each provision also has a "good faith" defense. That is, a person is protected from liability if he can prove that he exercised reasonable internal supervision against securities violations. *See, e.g. Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1134-1135 (9th Cir. 1975), *cert. den.* 423 U.S. 1025 (1975). In light of Sections 20(a) and 15 and the *expressio* rule, Sternbach submits that it is fair to conclude that Congress intended the "controlling person" provisions of the securities law to be the exclusive method of imposing liability on employers.[17]

The Circuit Courts are divided on the question of whether *respondeat superior* is applicable to Section 10(b) and other provisions of the securities law, or, whether the statutory "controlling person" provisions are the exclusive means for imposing vicarious liability. The majority of the Circuit Courts have held

17. *See* Fischel, "Secondary Liability . . .", 69 *California Law Review* at 86-87, where it is noted that in the absence of recognizing the "controlling person" provision as the exclusive method for imputing liability, Plaintiffs can circumvent the "good faith" defense available to "controlling person" Defendants by simply pleading *respondeat superior*, which has no "good faith" defense. This inherent unfairness caused one commentator to remark:

> "[S]pecific requirements of the express liability provisions are essentially nullified if Plaintiffs may sue for the same statutory violation under an implied right of action that is not subject to the barriers contained in the express provisions. Such nullification causes serious disruption of a carefully designed regulatory scheme since Plaintiffs will enjoy procedural or substantive advantages not intended by Congress."

Comment, "Implied Rights of Action in Federal Legislation: Harmonization Within the Statutory Scheme", 1980 *Duke Law Journal* 928, 940.

that the "controlling person" provisions and *respondeat superior* can both be utilized to impose vicarious liability.[18] The Third, Eighth and Ninth Circuits hold otherwise.[19]

The Court of Appeals erred when it held Sternbach vicariously liable based on the acts of Trager, a part-time clerk. Neither Section 20(a) nor *respondent superior* can be fairly utilized to impute Trager's *scienter* to Sternbach. Section 20(a) is inapplicable because no such claim was pleaded by the Respondents. The *respondeat superior* doctrine is inapplicable because based on the rules of statutory construction provided for in *Touche Ross* and *Transamerica*, a *respondeat superior* remedy is not implied in Section 10(b) private Causes of Action.[20]

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18. *See, Marbury Management* v. *Kohn*, 629 F.2d 705 (2d Cir. 1980), *cert. den.* 449 U.S. 1011 (1981); *S.E.C.* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976); *S.E.C.* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *Sennott* v. *Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973); *cert. den.* 414 U.S. 926 (1973); *Richardson* v. *MacArthur*, 451 F.2d 35 (10th Cir. 1971); *Armstrong, Jones & Co.* v. *S.E.C.*, 421 F.2d 359 (6th Cir. 1970), *cert. den.*, 398 U.S. 958 (1970); *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. den.* 390 U.S. 951 (1968).

19. *See, Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978); *Roches Bros., Inc. (Roches II)* v. *Rhoades*, 527 F.2d 880 (3rd Cir. 1975); *Zweig* v. *Hearst Corp.*, 521 F.2d 1129 (9th Cir. 1975), *cert. den.* 423 U.S. 1025 (1975); *Klapmeier* v. *Telecheck Int'l, Inc.*, 482 F.2d 247 (8th Cir. 1973). The Third Circuit's view on this matter was somewhat modified in *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175 (1981), *cert. den.* ___U.S.___, 102 S.Ct. 1427 (1982). In that case, the Court held that where a "stringent duty to supervise its employees arose" [*id.* at 184], an exception to the exclusive remedy of Section 20(a) would arise. Based on this theory, the Court held the accounting firm of Coopers & Lybrand liable for the Section 10(b) violations of an associate accountant, who worked on substantive tax matters under the direct supervision of four Coopers & Lybrand partners, because Coopers was in a "position in which the investing public would place their trust and confidence in it." [*id.* at 183]. At the same time, the Third Circuit emphasized "that the doctrine of respondeat superior, though applicable in this case, has not been and should not be widely expanded in the area of federal securities regulation" [*id.* at 183]. The Court noted that this Court has not addressed the question [*id.* at 181 n.5]. Compare *Sharp* with the case at bar where the Second Circuit has held an accounting firm liable based on the *scienter* of a part-time clerk who counted inventory.

20. Moreover, even if applicable, it is questionable whether the doctrine should ever be extended so far. The Court of Appeals holding that Sternbach is liable based on the *scienter* of a part-time clerk has extended as limitless the parameters of an accountant's liability under the federal securities law. *Cf. Sharp* v. *Coopers & Lybrand, id.*

II

THE COURT OF APPEALS ERRED WHEN IT DID NOT REACH THE QUESTION OF WHETHER RECKLESS BEHAVIOR CAN SATISFY THE ELEMENT OF *SCIENTER* IN A SECTION 10(b) "AIDING-ABETTING" CLAIM

The Court of Appeals again erred in the first so-called "fact" of its "combination" analysis with respect to a key factual matter. The Court erred when it held:

> "[T]he [district] court's conclusion that Sternbach lacked actual knowledge [of the fraud] is inconsistent with the *jury's finding . . . that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud.*" [Emphasis Added]. [A59-60].

The jury did *not* find that co-Petitioner Trager had "actual knowledge of the fraud" while engaged as a part-time clerk for Sternbach. In Special Interrogatory "3" [A72-73], the jury found that for years ending February 28, 1967 and 1968, the applicable time periods of that Interrogatory during which Trager was employed at Sternbach, Trager:

> ". . . participated in the preparation and dissemination of . . . [the financial statements] . . . to the public with *actual knowledge* of their truth or misleading nature *or* with a *reckless disregard* of their truth or falsity" [Emphasis Added].

Thus, the Court of Appeals erred when it held that the jury found that Trager had "actual knowledge of the fraud," and such actual knowledge should be vicariously imputed to Sternbach. The jury found that either Trager participated with actual knowledge of the fraud or acted recklessly. Assuming *arguendo* that Trager's *scienter* could have been imputed to Sternbach on a *respondeat superior* theory, the intent to defraud standard of *scienter* could not have been imputed to Sternbach because the jury did not indicate whether Trager possessed an intent to defraud the Respondent class members.

In light of the jury's disjunctive finding, that Trager either intended to defraud or acted recklessly, the Court of Appeals wrongly decided "not [to] reach the question whether Sternbach . . . should have been judged under a recklessness standard [of *scienter*]," rather than the District Court's standard of actual intent to defraud [A59]. The Court of Appeals should have adjudged Sternbach under the standard of actual intent, and in the absence of a jury finding that Trager acted with actual intent to defraud, Sternbach should not have been held liable.[21]

This Court has expressly reserved the question of whether actual intent to defraud is the sole means for satisfying the Section 10(b) requirement of *scienter*, or, whether reckless behavior will also suffice. *Aaron* v. *S.E.C.*, 446 U.S. 680, 686 n.5 (1980); *Ernst & Ernst* v. *Hochfolder, supra*, 425 U.S. at 193 n.12.

The Circuit Courts have generally held that reckless behavior will satisfy the element of *scienter* in a primary Section 10(b) Cause of Action.[22]

The Circuit Courts are less settled on the question of whether recklessness will satisfy the *scienter* requirement of Section 10(b) "aiding and abetting" liability.[23]

The Second Circuit has held that reckless conduct can satisfy the *scienter* element of Section 10(b) "aider-abettor" liability only where a Defendant owed a "fiduciary duty" to the Plaintiff. *Edwards & Hanley* v. *Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484-485 (2d Cir. 1979), *cert. den.* 444 U.S. 1045

21. In the alternative, and assuming *arguendo* that *respondeat superior* is implied in Section 10(b), this Court can remand this case for a determination of whether Trager, while employed at Sternbach as a part-time clerk in 1967, 1968 and early 1969, actually intended to defraud the Respondent class of Solitron shareholders.

22. *E.g., Healy* v. *Catalyst Recovery, Inc.*, 616 F.2d 641 (3rd Cir. 1980); *Keirnan* v. *Homeland, Inc.*, 611 F.2d 785 (9th Cir. 1980); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *I.I.T.* v. *Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Sundstrand Corp.* v. *Sun Chem Corp.*, 553 F.2d 1033 (7th Cir. 1977), *cert. den.* 434 U.S. 875 (1977).

23. In *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir. 1978), *cert. den.* 439 U.S. 1039 (1978), a three-prong test for aider-abettor liability was adopted. The test requires proof of (1) fraud by the primary violator; (2) knowledge of the primary fraud, and (3) substantial assistance.

(1980); *Rolf* v. *Blyth, Eastman Dillon & Co., supra*, 570 F.2d at 44. In the case at bar, the Second Circuit refused to decide whether Sternbach owed the Respondents a "fiduciary duty", and whether, accordingly, Sternbach should be adjudged under the recklessness standard [A59]. The Second Circuit did note that three New York Southern District Courts were split on the question of whether accountants should be adjudicated under an actual intent or recklessness standard of *scienter*. [A57-58]. Most recently, in *Decker* v. *Massey-Ferguson, Ltd.*, Slip Opinion dated June 3, 1982 [Docket No. 81-7446], the Second Circuit declined to decide whether corporate directors, alleged to be Section 10(b) "aider-abettors," should be adjudicated under an actual intent or recklessness standard.

Other Circuit Courts have reached conflicting results when defining the *scienter* standard applicable to "aiding-abetting" liability. The Fifth Circuit in *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975), held that differing standards of *scienter* should be applied, dependent on the alleged "aider-abettor's" duty of disclosure to the Plaintiff. As stated by Judge Goldberg of that Court:

> "When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter." [*Id.* at 97].

On the other hand, the Third, Sixth, Seventh and Tenth Circuit Courts have held that only actual intent to defraud, or conduct sufficiently equivalent thereto, will satisfy the *scienter* element.[24]

This Court has reserved the question of whether reckless conduct can constitute "scienter". The Circuit Courts are split on

24. *Edward J. Mawod & Co.* v. *S.E.C.*, 591 F.2d 588, 595-596 (10th Cir. 1979); *Mensen* v. *Consol. Dressed Beef Co., Inc.*, 579 F.2d 793, 799-800 (3rd Cir. 1978), *cert. den.* 439 U.S. 930 (1979); *Landy* v. *Midwestern United Life Ins. Co.*, 259 F.Supp. 673, 680 (N.D. Ind. 1966) (motion to dismiss denied), 286 F.Supp. 702, 708 (N.D. Ind. 1968) (decision on the merits after trial), *aff'd* 417 F.2d 147 (7th Cir. 1969), *cert. den.* 397 U.S. 989 (1970).

the question with respect to "aider-abettor" liability. This Court is requested to grant certiorari to resolve the conflict among the Circuit Court decisions as to the nature of the element of *scienter* sufficient to establish a Section 10(b) "aiding-abetting" claim.

III

THE COURT OF APPEALS ERRED WHEN IT HELD THAT ACCOUNTANTS' PERFORMANCE OF AUDITING PROCEDURES AND TESTS CAN, STANDING ALONE, GIVE RISE TO AN INFERENCE OF FRAUDULENT INTENT UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

In the third so-called "fact" of its "combination" analysis, the Court of Appeals predicated its judgment of liability against Sternbach upon a determination that accountants' performance of various auditing procedures and tests can somehow provide a jury with grounds to infer the accountants' "fraudulent" intent under Section 10(b) of the 1934 Act. The Court of Appeals held as follows:

> "And in light of Sternbach's claims to have performed various costing procedures and tests on Solitron's 1967-1970 inventory, the jury might well have concluded that Sternbach knew that its certification of reports overstating inventory was fraudulent." [A60]

This holding, extending as limitless the parameters of accountants' liability under the federal securities law, is erroneous, and conflicts with holdings of this Court, and the Third and Sixth Circuits.

In *Ernst & Ernst* v. *Hochfelder, supra*, a Section 10(b) action against the accounting firm of Ernst & Ernst was dismissed by this Court in the absence of the accountants' fraudulent intent. This Court defined the requisite showing of fraudulent intent under Section 10(b) as "a mental state embracing intent to deceive, manipulate or defraud." Under this standard, this Court dismissed the Section 10(b) claim against Ernst & Ernst, although, as here, the accounting firm was acknowledged to have

performed various auditing tests and procedures. The Plaintiffs' specific factual claim against Ernst & Ernst was that it had failed to detect management's fraud, which fraud would have been detected had Ernst & Ernst properly audited management's internal accounting controls. Ernst & Ernst defended by claiming that it had conducted its audit in accordance with the "Generally Accepted Auditing Standards" promulgated by the American Institute of Certified Public Accountants, and, in any event, it did not act with *scienter*. This Court dismissed the Section 10(b) claim in the absence of proof that Ernst & Ernst's audit was conducted with fraudulent intent, thereby reversing the Seventh Circuit.

In *McLean* v. *Alexander*, 599 F.2d 1190 (3rd Cir. 1979), accountants were alleged to have violated Section 10(b) in view of their certification of Financial Statements that overstated accounts receivable. Plaintiffs alleged that the accounts receivable included certain "consignment" transactions which were improperly recorded as sales. As in *Ernst & Ernst*, the accounting firm's defense was that it had performed its audit in accordance with "Generally Accepted Auditing Standards," and, in any event, it did not act with *scienter*. In dismissing the Section 10(b) claim, the Court held that the accountants' audit, standing alone, could not sustain a 10(b) claim.[25]

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25. The Court stated: "The [accounting firm's] representation was, then, an expression of opinion based upon generally accepted auditing standards. [The accounting firm of] C&S could be held to have the necessary scienter only if the evidence supports an inference that when it expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion. . . Although the defendants contended these sales had occurred, testimony by agents of L.B. Smith, Robbins, and Southern Laser established to the satisfaction of the Court that the sixteen transactions were in the nature of consignments. There was no evidence that Schiavi, the [accounting firm] partner in charge of the audit, had actual knowledge of the consignment sales. Thus [the accounting firm] could be held to have the requisite scienter only if the investigation it made, and the knowledge it had, give rise to an inference that it 'must have been aware' of the risk that the accounts receivable item was misleading. Upon examination of the evidence bearing on Schiavi's investigation of the four questioned accounts, we conclude that such an inference was not permissible in this case." 599 F.2d at 1198-1199.

The Sixth Circuit reached a similar result in *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980), *cert. den.* 449 U.S. 1067 (1980). The Court found that the accounting firm of Peat, Marwick, Mitchell & Company had, in its preparation of audited Financial Statements, acted negligently [*id.* at 426-428]. However, the Court did not find that a negligent audit could, standing alone, give rise to an inference of *scienter* and accordingly dismissed the Complaint.

In the instant case, the Court of Appeals holding that an accountant may be inferred to have acted with fraudulent intent based merely on the performance of certain auditing tests manifestly conflicted with this Court's holding in *Ernst & Ernst*, and the Third and Sixth Circuits' holdings in *McLean* and *Adams*.

CONCLUSION

For the foregoing reasons, the Petition of Louis Sternbach & Company for a Writ of Certiorari should be granted in all respects.

Dated: August 10, 1982

Respectfully submitted,

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Memorandum and Order of the District Court Granting Sternbach's Motion for Judgment Notwithstanding the Verdict

United States District Court

SOUTHERN DISTRICT OF NEW YORK

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75 Civ. 1369 (CLB)

HOWARD SIROTA, *et al.*,

Plaintiffs.

—against—

SOLITRON DEVICES, INC., *et al.*,

Defendants.

Memorandum and Order

BRIEANT, J.

This class action, brought on behalf of purchasers of shares of Solitron Devices, Inc. against the company, Solitron Devices, Inc. (hereinafter Solitron), its officers, Benjamin Friedman, James P. Barry and James S. Trager, and its accountants, Louis Sternbach & Co. (hereinafter Sternbach), was tried to a jury which returned a general verdict for the plaintiff class, and also answered Special Interrogatories, pursuant to Rule 49(b), Fed. R. Civ. P. Familiarity therewith is assumed. Defendants Solitron, Friedman, Barry and Trager have moved for judgment notwithstanding the verdict, pursuant to Rule 50(b), Fed. R. Civ. P., or in the alternative, for a new trial, pursuant to Rule 59(a), Fed. R. Civ. P. Defendant Sternbach has also moved for judgment notwithstanding the verdict as well as for an order granting it contribution-over on its cross-claims against the co-defendants. The contribution claims were tried to the Court without a jury.

The principal allegations of the amended complaint were based on violations of Section 10(b) of the Securities and Exchange Act

of 1934, 15 U.S.C. § 78j and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240 10b-5. Specifically, the case was tried on the theory that Solitron, the stock of which is publicly traded, and the individual defendants violated Rule 10b-5(2) and polluted the market, by intentionally issuing annual reports and financial statements which contained material false representations as to the company's sales, income, inventory and accounts receivable, as well as material omissions as to the true financial condition of the company. Defendant Sternbach was alleged to be an aider and abettor of the primary securities law violation. A pendent state claim of common law negligence against the defendant Sternbach was also tried to the jury.[1]

For convenience, we set forth the background of the litigation and consider how it arose. Defendant Solitron, is a semi-conductor manufacturer and by virtue of its government contracts, a small proportion of its business primarily involving its branch at Riviera Beach, Florida, was subject to the Renegotiation Act of 1951, as amended. The Act, derived from legislation in effect originally during World War II to prevent a repetition of claimed "war profiteering" believed to have been committed during World War I by so called "merchants of death," limited the amount of profits a contractor or subcontractor could earn on government contracts and provided for an administrative recapture of any excess to be determined after completion of the contracts. In 1972, the United States Renegotiation Board "determined," administratively, that Solitron had realized renegotiable profits, subject to recapture, of $3,200,000 attributable to fiscal year 1967 (Pltf. Ex. 69) and renegotiable profits of $4,400,000 attributable to fiscal year 1968 (Pltf. Ex. 70).

Following the usual procedure in such matters, Solitron sought administrative review of this assessment. It retained Mr. Alexander Kirk who testified at trial. Mr. Kirk is not a lawyer; he describes himself as a renegotiation consultant. His professional

work includes the representation of government contractors at the investigatory and administrative levels, to assist them in avoiding or minimizing recapture. Advised by Mr. Kirk, Solitron, in order to obtain a more favorable determination of its liability, retained Price Waterhouse & Co. to investigate, and prepare reports for Solitron (Pltf. Ex. 9 & 9a). The reports, which are not audits, indicated that the Board's determination of excess profits may have been in error, because it relied on overstated sales and inventories in the certified financial statements of Solitron for those years. These financials, included in Solitron's annual report, were prepared by Sternbach from Solitron's books and records and were signed by Friedman. Plaintiffs contended at trial that the misrepresentations of fact in the corporation's certified financials disclosed in the Price Waterhouse reports and in a letter written by defendant Trager, acting for Solitron, to the Renegotiation Board (Pltf. Ex. 115) taken together, demonstrated significant prior violations by the defendants of the federal securities laws.

At the time of the initial renegotiation assessment, Solitron disclosed in its financial statements that a liability assessment had been rendered, and was being contested but failed to disclose the amount so assessed. The disclosure reads as follows:

> "A portion of the company's business is subject to The Renegotiation Act of 1951, as amended. Determinations of excessive profits in fiscal years 1967 and 1968 have been made by The Eastern Regional Renegotiation Board but are being contested by the company. The Statutory Board is presently reviewing The Regional Board's determinations. The fiscal years 1969 and 1970 are being reviewed by The Regional Board but such review is not expected to be completed until the earlier years are settled.
>
> Management believes that . . . no significant refunds will be required on renegotiable business."

(Annual Report for fiscal year 1972, Pltf. Ex. 25.) Similar disclosures were made in the annual reports for fiscal years ending 1973 and 1974. (Pltf. Ex. 26 and 8.)

On this basis, plaintiffs alleged that this constituted a material omission in violation of Rule 10b-5. The latter claim was not asserted against defendant Sternbach because it was not Solitron's accountant during this period.

The plaintiff class of purchasers of Solitron securities during the 1967-1975 period was divided into two subclasses[2] to correspond to the time periods during which the alleged misrepresentations or omissions were made in the Solitron financial statements. The first subclass consists of those persons who purchased Solitron securities from May 5, 1967 to December 16, 1970[3] and who thereafter either sold said stock at a loss or continue to hold said stock. The claims of this class submitted to the jury concerned misrepresentations of inventory, sales and therefore profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970. Although plaintiffs also asserted a claim based upon misrepresentations of inventory in the financial statements for the fiscal year ending February, 1969, that claim was dismissed by the Court. (Tr. 1513-14).

The second subclass consists of those persons who purchased Solitron securities from June 8, 1972 to January 27, 1975 and who thereafter either sold that stock at a loss or still hold it. The claim submitted to the jury on behalf of these shareholders was based on the failure to disclose in the financial statements for the period including fiscal year ending February 28, 1972 through fiscal year ending February 28, 1974 the amount of contingent liability which had been determined by the United States Renegotiation Board to be owed by Solitron. Because the claims of

each subclass depend upon distinct misrepresentations or omissions in the financial statements, the Court will consider them separately in determining the post-trial motions.

1. Subclass No. 1

We turn first to consider the claims of the first subclass, as to which plaintiffs contended that the financial statements for the fiscal years 1967, 1968 and 1970 contained misrepresentations as to the amount of inventory, and that certain transactions between Solitron and AEL Israel, between Solitron and Best & Raynor, and between Solitron and JFD Electronics were characterized improperly as sales when there were merely consignments of unsold goods. The jury answered Special Interrogatories in the affirmative as to the individual elements of this claim and also stated the percentage by which it found the misrepresentations had inflated the market price of Solitron securities for each of the three years specified.

The Solitron defendants now seek to challenge the jury verdict on various bases. They claim that:

> "(1) there was insufficient evidence before the jury to sustain its answers to the special interrogatories and its verdict, (2) the verdict is contrary to the weight of the evidence and (3) at no time did any of the named Plaintiffs have a claim with respect to Solitron's books and records for the period ending December 16, 1970. Defendants also move for a new trial pursuant to Rule 59(a) on the ground that it was prejudicial error for the Court to refuse to permit the introduction of the proferred testimony of Bernard Malina, Esq., the attorney who represented Solitron in the AEL Israel transaction, concerning matters relating to Benjamin Friedman and scienter." (Memo of Law, filed Nov. 12, 1980, at 1-2).

Supplementary affidavits of various persons connected with the AEL Israel transactions were submitted by the Solitron defendants in support of the motion for a new trial, apparently on the basis of newly discovered evidence. Defendant Sternbach has filed an answering affidavit.

Defendant Sternbach also moves to set aside the verdict of the jury, as it pertains to the claims of the first subclass, on the ground that there was insufficient evidence to sustain the determination of its liability as an aider and abettor or for common law negligence under New York law.

EVIDENCE PRESENTED AT TRIAL.

The defendants' motions must be evaluated against the applicable standard. In order to enter judgment notwithstanding the verdict, the trial court must find that "the evidence is such that, without weighing the credibility of the witnesses or otherwise considering the weight of the evidence, there can be but one conclusion as to the verdict that reasonable men could have reached." *Simblest* v. *Maynard*, 427 F.2d 1, 4 (2d Cir. 1970) (citations omitted). In this case, the evidence must be viewed in light most favorable to the plaintiffs and they must be given the benefit of all the favorable inferences which the evidence fairly supports. *Mattivi* v. *South African Marine Corp.*, 618 F.2d 163, 167 & n.3 (2d Cir. 1980); *Lebrecht* v. *Bethlehem Steel Corp.*, 402 F.2d 585, 589 (2d Cir. 1968).

A motion for a new trial pursuant to Rule 59(a), Fed. R. Civ. P., is addressed to the discretion of the trial judge, whose duty it is to assure that there has been no miscarriage of justice. *Beveino* v. *Saydjari*, 574 F.2d 676, 684 (2d Cir. 1978). Before granting a new trial, the Court must find that the weight of the evidence is plainly against the non-moving party. *Id.*

Memorandum and Order of the District Court Granting Sternbach's Motion for Judgment Notwithstanding the Verdict

The jury was charged that the plaintiff was required to prove the following five elements by a preponderance of the evidence before it could find a primary violation of Rule 10b-5 by Solitron or any of the individual defendants:

> "The first element is that in connection with the purchase or sale of Solitron Devices securities, namely stock, the defendants made representations of fact. In connection with this element you can treat the annual reports and the press releases, which are in evidence in this case, as representations of fact.
>
> The second element is that these representations or any one or more of them contained one or more untrue statements of fact or omitted facts which were necessary to make the statement not misleading in light of all the circumstances then existing.
>
> The third element is that the misrepresentations or omissions must have been material. . . .
>
> The fourth element must be that the defendants, or the defendant whose case you are considering, acted with scienter. . . .
>
> The fifth element which must be shown is that the defendants' conduct caused damage to the class of persons who purchased Solitron stock during the period in which the misrepresentations were outstanding or the omissions were withheld from the public. That damage would be present if it be found by you that the misrepresentations or omissions, if there were any, caused the market price of Solitron stock to be inflated over what it would have been had there not been any Rule 10b-5 violation." (Tr. 1583-84.)

The Solitron defendants do not dispute that the financial statements for the fiscal years ending 1967, 1968 and 1970 contain overstatements of inventory. Nor do they contest that the contract between Solitron and AEL whereby AEL agreed to distribute Solitron products in Israel was, as it most clearly states, a

consignment arrangement and that the treatment of goods consigned thereunder as sales included on the 1970 financials was in error. Neither do they contest the jury finding that the misrepresentations taken as a whole for these three years were material.[4] They do contend, however, that the evidence at trial was insufficient to establish that any of the individual defendant officers sued or Solitron itself acted with the requisite scienter, and that it did not support the jury's determination of damages.

The Solitron defendants have failed to establish that they are entitled to a judgment notwithstanding the verdict or a new trial on either basis.

In order to satisfy the element of scienter, plaintiff was required to prove that the defendant whose case is being considered participated in the preparation or dissemination of the financial statements with actual knowledge of the misrepresentations or with a reckless disregard for their truth or falsity. *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *IIT, An International Investment Trust* v. *Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1300-02 (2d Cir. 1973).

The misrepresentations in the financial statements for the years ending 1967, 1968 and 1970 were based on overstatements of inventory and improper accounting for consignments as if they were sales. Solitron admitted these overstatements in its presentation to the Renegotiation Board in 1974. The report to the Renegotiation Board was submitted by Mr. Friedman, and contained memoranda from the other officers of the company, Mr. Trager and Mr. Barry. There is no question that as of 1974, the three individual defendants and Solitron had actual knowledge of the misrepresentations sufficient to satisfy the scienter requirement if the financial statements had been issued at that time. The issue is whether the defendants possessed the actual knowledge at the time the financial statements were issued. The

defendants argue now, as they did before the jury, that the overstatements of inventory were not known until the late 1970's and could not have been discovered without the time and motion study, and its computer capability, both of which postdated the financial statements.

They also argue that they did not learn that certain "sales" were actually "consignments" until 1974. These arguments were made to the jury and are merged in the jury verdict. The question of intent is not capable of exacting proof. It is a question of fact, peculiarly within the scope of the jury function to determine from all the evidence presented and drawing all logical inferences. There was sufficient evidence presented as to the intent of each individual defendant, and as to corporation, Solitron, to sustain the jury verdict. The case was proved principally through the admissions of the defendants made to the Renegotiation Board and documents contemporaneous with the fraud. Plaintiffs proved that Solitron and the individual defendants engaged in an intentional effort to exaggerate or "hype" the sales and profits of Solitron and thereby mislead prospective stock purchasers. A reasonable jury could reject their claims at trial that they relied on the expert advice of their accountants. Reasonable jurors could find that the Solitron defendants purposely contrived to inflate the company's financials. They could also find that they knowingly completed and gave to Sternbach false inventory certificates and Sternbach questionnaires in order to ensure that the inflated sales and inventory figures would go undetected.

Although the goods shipped to AEL Israel were booked as "sales," the plain language of Solitron's contract provided that AEL Israel was to be merely a distributor of Solitron semiconductor devices, and specifically referred to the transaction as a consignment.

> "2. This Agreement shall apply during its term to all *consignments* of merchandise made by Solitron to A.E.L.

> during the term of this Agreement. A "*consignment*" within the meaning of this Agreement, shall exist when Solitron shall deliver merchandise which is received by A.E.L. and which Solitron shall designate, in writing, as consigned merchandise. Said *consigned* merchandise shall hereinafter be referred to as the "merchandise'. Title to the merchandise shall not pass to A.E.L." (Pltf. Ex. 9) (emphasis added.)

This contract, which was concealed from the auditors, also provided that each invoice pertaining to this agreement would state *on its face* that the merchandise was being shipped on consignment:

> "Each shipment of merchandise under this Agreement shall have a Consignment Number of the series 001-100 attached thereto. Solitron shall place the following endorsement on each invoice of consigned merchandise:
>
> > 'The within merchandise bearing Consignment Number is delivered by Solitron Devices, Inc. to A.E.L. Israel Limited, pursuant to an Agreement dated January 27, 1970.' "

None of the invoices for goods shipped to AEL Israel contained this required endorsement, nor did they indicate, in any other manner, the true nature of the transaction. Each on its face appeared to record a sale. No auditor who examined *any* of the invoices would be apprised that it was a consignment rather than a sale. The jury could also find that the "sales" to AEL Israel were booked as such at a point in time close to the end of the fiscal year 1970, in an attempt to hype the sales, and thereby the profits of the company. The jury could apply its logic, its common sense and experience to find that the last sales booked in any fiscal year are the most profitable, because the overhead and administrative expenses of a company have already been covered. The jurors could conclude on the totality of the evidence that the $1,053,468

recorded as sales to AEL Israel, in itself approximately 4% of the year's total sales of $30.9 million, was material misrepresentation and inflation of earnings. Mr. Friedman himself was the "salesman" in charge of the AEL account (Tr. 420). This was not the first time that Solitron included consignment shipments as sales in order to hype its profits. Plaintiffs proved that in 1969 consignment shipments to Best & Raynor (in the United Kingdom) amounting to $443,780 were improperly included as sales. Similarly, in 1969 and 1970, shipments to JFD Electronics, a company run by Mr. Robert Dressler (with whom Mr. Friedman was acquainted and with whom he spoke about the transaction), in the amount of $468,634 were also booked as "sales." The jury could consider this evidence of prior, similar acts as well as the paper trail left by the AEL transaction in determining the intent of the defendants. An inference of fraud is compelling.

The jury had sufficient evidence before it to support a conclusion that the Solitron defendants intentionally polluted the market with false and fraudulent sales and profit figures, and only disclosed the true information when it became helpful to Solitron in its Renegotiation dealings to do so. Therefore, the Court rejects the defendants' contention that there was insufficient evidence on this claim to support the jury verdict. Nor do I find that the verdict is so contrary to the weight of the evidence so as to require a new trial.

Each defendant has also argued that his individual involvement in the preparation and dissemination of the false financial statements and his individual knowledge is insufficient to sustain a finding that he intentionally violated Rule 10b-5. This is plainly not the case.

Mr. Trager participated in the preparation of the financial statements as a member of the Sternbach audit team for the fiscal years ending 1967 and 1968 and was the comptroller of the Tappan Division of Solitron from June 1969. He currently serves

as Treasurer of Solitron. Mr. Trager coordinated the presentation made to the Renegotiation Board seeking a reduction in the assessment levied against Solitron. When these company officials learned that the inventory write-down and resulting financial loss it had incurred in 1971 could not be applied for Renegotiation purposes to reduce the profits earned in previous years, they attempted to show that the profits of earlier years had been overstated when reported, and were "phony."

It is important to note that when the time came to dispute the amount of profit, Mr. Trager knew where to look for evidence. Trager testified that it was he who informed the Renegotiation Board that the inventory for the years 1967 to 1970 had been overvalued. He admitted that the suggestion that the revaluation of inventory would yield overpriced inventories in earlier years was his. It was not an endeavor undertaken pursuant to a suggestion of the Renegotiation Board (Tr. 245). In the presentation to the Renegotiation Board, the build-up of inventory was cited in support of the claim that inventory was overstated. If this be evidence of overstatement, it was equally available when the original financial statements were prepared. He also prepared information to submit to the Renegotiation Board, admitting that the consignment transactions with three companies, AEL Israel, Best & Raynor and JFD Electronics were recorded improperly on the books of Solitron as sales in the year of shipment. To substantiate this argument before the Renegotiation Board, he relied on letters he received from each of these companies indicating that each was acting as a distributor on a consignment basis. (Tr. 164, 165). Although he had already received the letters for Best & Raynor and JFD Electronics, he, nevertheless, in January 1970, prepared and signed an internal control questionnaire for Sternbach and in response to an inquiry as to whether consignments were under inventory control, checked "not applicable." (Pltf. Ex. 32). He received a copy of the letter sent from AEL

Israel to Mr. Cole at Sternbach prior to the certification of the financials and issuance of the 1971 annual report but after the closing date of fiscal year 1971. Mr. Trager had these three letters in 1970-71. In 1974, he contended for the first time that they showed the transactions involved were consignments. Mr. Trager was the source of the information in the Price Waterhouse Report dealing with the consignments. (Pltf. Ex. 9). Although he testified that he came to this conclusion only after obtaining a legal opinion in 1974, the jury could infer that he already knew these transactions were consignments and lied about the state of his knowledge. Here again, he knew where to look.

Mr. Barry was charged as a defendant only in respect to Solitron financials for the year ending February 1970, during which he was employed as the head of its accounting department. In preparation for the Sternbach audit, he certified that the inventory for fiscal year 1970 was taken at his direction and that each item was priced at the lower of cost or market. (Tr. 528, 529). These figures were then provided to Sternbach, and formed the basis for the financial statements and Sternbach's opinion. Mr. Barry testified that he did not spotcheck the inventory sheets for accuracy in 1970, nor did he attempt to ascertain the method by which the items on the sheets were "costed" (Tr. 526). He testified further that no person to his knowledge attempted for Solitron to verify the inventory figures for this period. In fact, in a letter written to the Renegotiation Board he admitted the inadequacies of the accounting procedures employed (Pltf. 101). This was evidence from which the jury could conclude that Mr. Barry acted with scienter when he certified the inventory to Sternbach for fiscal year ending 1970.

The Solitron defendants contend in their Reply Brief filed on this motion, that the amount attributable to 1970 recosting errors was minimal and that the materiality requirement has not therefore been met. This argument presupposes that the jury found

that the figures contained in Solitron's 1974 presentation to the Renegotiation Board were unavailable in 1970. Clearly this latter contention was not accepted by the jury, and properly so.

Mr. Friedman was the president, chief executive officer and the overall manager of Solitron. The jury could find that he participated in the preparation or dissemination of the financial statements in the annual report issued over his signature and did so with scienter. He was in constant communication with the Riviera Beach division and was aware of its sales. He also knew that the inventory figures were increasing, and knew the effect this had on the profits of the company. He testified at trial that "What's written in the [Price Waterhouse] report I agree with." (Tr. 491). That report on inventory overvaluation cited the buildup on inventory as evidence of the fact.

With respect to the consignment transactions, Mr. Friedman personally negotiated and signed the written contract with AEL Israel, which plainly specified a consignment arrangement (Pltf. Ex. 9). The testimony of Dr. Reibman, the principal of AEL Israel, showed that the written and executed agreement accorded with his understanding of the arrangement. Mr. Friedman contends, however, that the first draft of the agreement provided that the risk of loss would be on AEL, indicating that the transaction was a sale. He testified that he believed the final contract continued to provide for a sale. The jury could conclude from the evidence presented that Mr. Friedman knew the difference between a consignment and a sale, although he testified to the contrary. And the jury could conclude that he read the AEL contract before he signed his name to it, and thereby learned that it provided for distribution on a consignment basis, and that risk of loss was placed on Solitron.

Neither do I find any prejudicial error resulting from the exclusion of Mr. Malina's proffered testimony, which would warrant

the grant of a new trial. Mr. Malina was the attorney for Solitron who participated in the drafting of the AEL Israel consignment contract. His testimony was offered at trial on the issue of whether Mr. Friedman acted with scienter. An offer of proof was taken outside the hearing of the jury, as contemplated by Rule 103, F.R.Evid., and the proof was excluded, pursuant to Rule 403, F.R.Evid. as lacking probative value. The proffered testimony of Mr. Malina failed to demonstrate, as defendant now contends, that Mr. Friedman was unaware that the contract he signed varied from the initial understanding that he now claims he reached with AEL, or that he was unaware of the difference between a consignment and a sale, or that he relied on the expert advice of his attorney in treating this substantial transaction as a sale.

The offer of proof demonstrated that the signed contract differed from the original or first draft of a proposed agreement between the parties. This is not unusual. Beyond that, the most that Mr. Malilna's testimony showed was his inability to recall the surrounding details. The lack of any probative value on the question of scienter is apparent from the testimony given. With respect to the original meeting between Mr. Friedman and AEL representatives, Mr. Malina testified:

> Q. Was anything said with respect to the kind of relationship, if any, that was to exist between Solitron and AEL Israel? A. *None that I can recall.* (Emphasis added) (Tr. 1191).

Mr. Malina yielded no information relevant to Mr. Friedman's knowledge or intent at that time:

> Q. Was there any discussion between you and Mr. Friedman prior to the time you participated in drafting relating to the subject of who would assume the risk of loss

with respect to the goods that were going to be shipped? A. *I don't recall* a conversation directed to that particular point.

Q. Are you saying that there was no such conversation? A. I can't say with absolute certainty that the conversation never took place but *I don't recall any.*

Q. Do you remember what the initial drafts of the agreement provided with respect to who would assume the risk of loss, whether it was Solitron, AEL or some other party? A. I believe in the initial draft it was AEL that was to assume the risk of loss. (Tr. 1192-93) (Emphasis added).

Finally, Mr. Malina was questioned about the executed agreement:

Q. Did there come a time that the drafts that were exchanged changed that provision so that the risk of loss was to be borne by Solitron? A. Yes, I believe that is so.

Q. Did you discuss the change with Mr. Friedman? A. I don't recall a *specific* discussion with Mr. Friedman on that point.

Q. Did you ever discuss with Mr. Friedman that the final agreement that was executed provided that the merchandise was to be consigned to AEL Israel? A. *I don't recall a specific conversation* on that point.

Q. Did you ever tell Mr. Friedman that the agreement provided that the merchandise was to be consigned to AEL Israel? A. *I don't recall the specific conversation.* I can— (Tr. 1194).

* * *

Q. Did you tell me a few minutes ago [outside the courtroom] that you never told Mr. Friedman that the agreement provided that the merchandise was to be consigned? A. Yes. That is essentially so, yes.

The Court: Were you under oath when you told him that?

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The Witness: No.
The Court: Do you understand you are under oath now?
The Witness: Yes.
The Court: Are you testifying truthfully now?
The Witness: Yes, I am.
The Court: Forget it, Mr. Morrison.
Q. Did you ever explain to Mr. Friedman what the work 'consignment' means in law? A. *I don't recall any such conversation,* no.
Q. Are you saying that you didn't tell Mr. Friedman?
The Court: He doesn't recall any such conversation.
A. I don't recall. (Tr. 1195-96) (Emphasis added)

This testimony does not demonstrate "Friedman's contemporaneous state of mind." (Def. Memo. of Law at 27). It does not show that Mr. Friedman believed the transaction to be a sale or even that he believed the original draft agreement terms had not been changed when the final agreement was presented for his signature. It does not prove any advice given to him by his attorney upon which he could be said to have relied. It shows nothing except that attorney Malina has a poor memory, and, like many potential witnesses, he will tell a litigant what the litigant wants to hear, so long as he is outside the courtroom and not under oath. There is no substance to defendants' claim of prejudice from the exclusion of this basically irrelevant testimony.

The Solitron defendants have submitted affidavits from three individuals involved in the arrangements surrounding the AEL contract in support of their motion for a new trial. These specifically concern a trip to Israel in April 1971 by Mr. Friedman and Mr. Cole. The affidavits of Dr. Riebman, Mr. Dor and Mr. Ravillan attempt to show that Mr. Cole of Sternbach was apprised of the true nature of the relationship between Solitron and AEL in April 1971, a date prior to the certification of the financial statements for fiscal year ending in February 1971.

They also show that Mr. Friedman was not a party to these discussions about the financial arrangements. This appears to be the basis for the argument that Mr. Friedman never knew the true nature of the transaction and instead relied on Mr. Cole, his accountant.

Dr. Riebman, the president of AEL Israel, says only that (Affidavit of Dr. Riebman, sworn to November 4, 1980):

> "Mr. Cole reviewed the financial aspects of the relationship between Solitron and A.E.L. Israel with Gideon Dor, the vice president of finance for A.E.L. Israel and Rony Ravillan, the Israeli attorney who was advising the parties. As I recollect, Mr. Friedman did not concern himself with the financial or legal aspects of the matter but was fully involved in the engineering and sales discussions. To my recollection, after our initial meetings I did not discuss the form of transaction with Mr. Friedman, his interest apparently being in the volume of anticipated business and market opportunities."

This is so much doubletalk and collected buzz words. He provides no specific information about the discussions.

Gideon Dor's affidavit, sworn to November 12, 1980, was specific. He now states that Mr. Cole was advised specifically that this transaction was a consignment:

> "Mr. Cole and I discussed the accounting transaction upon the sale of any of the semiconductor merchandise from the bonded warehouse. These discussions were summarized in my letter to Mr. Cole dated May 7, 1970 attached hereto as Exhibit 'A'. Mr. Cole and I discussed that the arrangement between AEL and Solitron was that of a consignment, and that any remittance to Solitron would only take place upon a sale of the consigned merchandise to a third party and subsequent collection."

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Rony Ravillan (Affidavit sworn to November 12, 1980) recounts the same conversation but with less specificity:

> "In April 1970, several Solitron personnel visited Israel. Among the Solitron personnel were Benjamin Friedman, Solitron President and other people, which to the best of my recollection included Mr. Edward Cole, the Accountant for Solitron. Among the subjects discussed with Mr. Cole were the legal procedures involved in the handling and accounting for money due Solitron upon the sale of the merchandise in the bonded warehouse and the setting up of Solidev Israel Ltd. and since the merchandise was received on consignment it was presumed that payments for the merchandise (by the respective customers) would only be made after a sale of said merchandise from the bonded warehouse."

The opposing affidavit of Mr. Cole, sworn to January 12, 1981, directly contradicts this claim:

> "I did not discuss with Mr. D'Or any of the matters referred to in his affidavit. Specifically, I deny discussing 'the nature of the financial arrangements between A.E.L. and Solitron'; the maintenance of the merchandise in a bonded warehouse in Israel; visiting any bonded warehouse in Israel; discussing 'the accounting transaction upon the sale of any of the semiconductor merchandise from' any bonded warehouse; 'that the arrangement between A.E.L. and Solitron was that of a consignment, and that any remittance to Solitron would only take place upon a sale of the consigned merchandise to a third party and subsequent collection.
> I did not meet with Mr. Ravillan at all and deny having any discussions with him. Moreover, I was not a member of any group with whom Mr. Ravillan had any discussions. He certainly did not inform me that merchandise would be held in a bonded warehouse or that it was received on consignment or that payment would only be made after sale of any merchandise."

Cole states that he met with Mr. Dor who showed him AEL's bookkeeping system. This system, he contends, was appropriate for recording actual purchases only. He also stated that he visited the AEL facility. Cole observed "open racks in their salesroom containing Solitron merchandise in addition to other electronic devices of other companies," and concluded "[t]his was not a bonded warehouse by any stretch of the imagination." These statements were consistent with his testimony at trial concerning the April 1970 trip to Israel. (Tr. 775-78, 1368-69).

The disparity between these affiants cannot be resolved without an evidentiary hearing to determine credibility. Assuming the accuracy of the affidavits submitted on behalf of defendants, however, I do not believe they warrant the grant of a new trial on the issue of liability of the Solitron defendants.

No showing has been made that this evidence was not known to defendants at the time of trial, or was not discoverable with due diligence, thereby justifying a grant of a new trial on the ground of newly discovered evidence. See, 6A J. Moore, Federal Practice, ¶ 59.08(3) (2d ed. 1979). In fact, at the hearing on this motion, the defendants' attorney stated that he had decided, presumably for valid tactical reasons, to forego cross-examination of Mr. Cole on this point. Nor do I find it likely that the evidence, if admitted, would change the verdict.

The Solitron defendants also contend that there was insufficient evidence to sustain the jury determination of damages. On the issue of damages, plaintiffs presented the expert testimony of two witnesses, Mr. Lieberman and Mr. Gorkiewicz. Mr. Lieberman computed the effect that public disclosure of correct figures, assuming them to be such, set forth in the Price Waterhouse Reports would have on earnings per share of Solitron stock during each year in issue. Mr. Gorkiewicz then gave his opinion as to what the market price of Solitron would have been if the correct earnings per share had been disclosed. His opinion was based on

his conclusion that proper market valuation of Solitron shares was best obtained by utilizing the earnings approach, that is, looking at earnings per share and the rate of growth. The verdict returned by the jury adopted Mr. Gorkiewicz's figures reduced by twenty-five percent. Defendants now argue that (1) the jury applied the expert's estimates to the wrong years; (2) there was no factual basis for his theoretical estimates; and (3) the jury's verdict constitutes an impermissible compromise verdict. First, defendants argue that Mr. Gorkiewicz'a estimates were based on a year-long period extending from the beginning to the end of the fiscal year which the periods set forth for the jury were determined by the dates the annual reports were issued. The year-long periods presented to the jury in Special Interrogatory No. 6a were stipulated to be the accurate time periods. There is no question that the parties considered these periods to correspond to the figures opined by Mr. Gorkiewicz. (See, Tr. 1413). A review of the transcript reveals that Mr. Gorkiewicz's estimates of inflation of market price were given in response to a question based on the same time period as appeared in the Special Interrogatories. The defendants' second point was argued to the jury and is merged in the jury verdict. The defendants presented the expert testimony of Mr. Rogalski to demonstrate that the earnings approach utilized by Mr. Gorkiewicz to value the stock was erroneous. They argued to the jury that investors do not purchase stock on the basis of earnings and that, in fact, after a brief period the price of Solitron continued to rise once the disclosure took place in 1971.[5] This presented an issue of fact which was resolved by the jury. The third contention in regard to the damage determination is that the verdict must be set aside as an impermissible compromise because the jury reduced Mr. Gorkiewicz's estimate of damages by twenty-five percent across the board. It is true that a jury may not compromise on liability.

Therefore, when a cause of action is brought to recover an undisputed sum of liquidated damages, a partial damage award will be set aside as a compromise verdict. See, *Banco Popular de Puerto Rico* v. *Deliz*, 407 F.2d 1388 (1st Cir. 1969); *National Fire Insurance Co. of Hartford* v. *Great Lakes Warehouse Corp.*, 261 F.2d 35 (7th Cir. 1958). When the amount of damages is in dispute, the jury is free to compromise on the issue of damages and adopt the figure it perceives as fair.

> "In many cased of unliquidated damages it is quite proper for a jury to compromise the differences of the parties where amount of the verdict is not so grossly inadequate as to render it a farce. Commendable as such practice may be, however, a jury cannot compromise an issue of liability."
>
> *National Fire Insurance Co. of Hartford, supra* at 38.

In this instance, there was no sum of liquidated damages nor a stipulated amount of damages. The jury was free to accept plaintiff's theory but to reduce the plaintiff's figures to compensate for exaggeration.

Named Class Representatives

The Solitron defendants also challenge the verdict by arguing that no named plaintiff is, or ever was, a proper class representative. They therefore ask the Court to decertify the class pursuant to Rule 23(c)(1), dismiss the individual claims of the named representatives and enter judgment in defendants' favor.

As originally certified, the first sub-class consisted of "those persons who purchased Solitron stock during the period from May 5, 1967 to [June 2, 1971] and who thereafter either sold said stock at a loss or still hold said stock." Memorandum Decision, February 14, 1979, at 3-4. The closing date of the class

corresponds to a date two days after the publication of the 1970 annual report which the plaintiffs stipulated correctly represented the fiscal 1970 sales and income.[6]

The appropriated closing date of this sub-class was in dispute throughout this litigation. The plaintiffs' claim was that the misrepresentations in the financial statements caused the market price of the shares to be inflated until the date on which full disclosure was made. They maintained that the appropriate closing date was the date when the market had assimilated the annual report for fiscal year 1971 which disclosed an inventory write-down of approximately Ten Million Dollars, that is, June 2, 1971. The Solitron defendants, however, contended that no shareholder who purchase shares after December 16, 1970 could have been damaged by this inflation because on December 14, 1970 Solitron issued a press release which disclosed an inventory write-down of approximately Seven Million Dollars. Recognizing that the Supreme Court has held in *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156 (1974) that the Court on a Rule 23 motion lacks power to "conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action," the Court certified the first sub-class as extending until June 2, 1971. Two of the named plaintiffs were purchasers of shares during this period. Family Restorations, Inc. purchased 400 shares in April, 1971; Howard Sirota purchased 25 shares in June, 1971. The plaintiffs tried the class claims on behalf of all purchasers within these time periods who continued to hold their shares after June 2, 1971. Because plaintiffs conceded that at least partial disclosure had occurred in December 1970, there was a question of fact for the jury to resolve as to the effect of that disclosure on any alleged inflation of the market price. The Court, therefore, requested, prior to the submission of the case to the jury, that the parties draft an appropriate interrogatory to submit to the jury on

this question. In lieu of this interrogatory, the parties advised the Court that they had stipulated that the class period would close on December 16, 1970.

> "The Court: Gentlemen, as I understand it, rather than modifying the interrogatory to be given to the jury as I invited you to agree upon a form of doing so, and I believe I did indicate if you couldn't agree I would modify it some way myself, but I understand that rather than agreeing on a modification or asking the Court to make one you have agreed on some other solution of the problem which is created by the press release of December 1970.
>
> Would you be good enough to state your understanding on the record?
>
> Mr. Oestreich [Plaintiff's counsel]: I think the understanding is that it is hereby stipulated and agreed by and among the parties that the class period which begins after the publication of the annual report of Solitron for the year ending February 28, 1967 will end upon the publication of the December 14, 1970 third quarter shareholder release by Solitron.
>
> And in conformance with your Honor's prior ruling, giving two days for the absorption of that information in the public marketplace, and said information having been published in the Wall Street Journal on December 16th, it is hereby stipulated that that class period will end on December 16, 1970.
>
> The Court: Is it so stipulated?
>
> Mr. Morrison [Counsel for Solitron defendants]: Yes, it is.
>
> The Court: Do you want the interrogatories amended as they now stand to put that as the cutoff date? Did you expect me to deal with that press release in any way—
>
> Mr. Rabin [Plaintiff's counsel]: No.
>
> The Court: —on the charge?
>
> Mr. Rabin: No, not at all. Just leave the interrogatory the way it is.
>
> The Court: All of you are in agreement?
>
> Mr. Morrison: Yes." (Tr. 1517-18).

The effect of this stipulation was to place the class representatives outside the class period. They are not, therefore members of the class entitled to recover. The defendants argue that there was no proof of any damage, that is market inflation, occurring after December 16, 1970 and that the named plaintiffs are not, and never were, proper class representatives. The basis of this argument is that their claims are not typical of those of the class as required by Rule 23(a)(3), Fed, R. Civ. P. and that the "case or controversy" requirement of Article III of the United States Constitution is not therefore met. No contention is made that the class representatives, or their attorneys, failed to provide adequate representation for the class interests.

The Court adheres to its earlier decision and finds that the class was properly certified on February 14, 1979. The analysis of that determination will not be recounted here. The question remaining is whether the class should be decertified because proof at subsequent trial, and/or the stipulation of their own counsel, barred the individual claims of the class representatives. Although the individual claims were barred, a viable controversy existed between the members of the class, as modified, and the defendants. When the case was submitted to the jury, there was a sufficient adverse relationship between the members of the class and the defendants to satisfy the case or controversy requirement of Article III of the United States Constitution and to allow them to succeed to the adversary position theretofore held by the class representatives. See *Franks* v. *Bowman Transportation Co., Inc.*, 424 U.S. 747 (1976); *Sledge* v. *J. P. Stevens & Co., Inc.*, 585 F.2d 625 (4th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979).

The class was certified prior to trial, the class claims were tried to the jury and the class members had an interest adverse to the defendants. I do not conclude that any benefit would result from

a dismissal at the close of trial, simply because the proof at trial demonstrated that the individual claims of the class representatives were barred.

In *East Texas Motor Freight System, Inc.* v. *Rodriguez*, 431 U.S. 395 (1977), the Supreme Court vacated a judgment where the Court of Appeals certified a class on appeal after the district court had dismissed the individual claims of the class representatives. The Court recognized that a different situation would exist if the class had been certified properly before trial and the class claims tried to the jury (431 U.S. at 406, n. 12):

> "Obviously, a different case would be presented if the District Court had certified a class and only later had it appeared that the named plaintiffs were not class members or were otherwise inappropriate class representatives. In such a case, the class claims would have already been tried, and, provided the initial certification was proper and decertification not appropriate, the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims. See, *e.g.*, *Franks* v. *Bowman Transportation Co.*, 424 U.S. 747, 752-57; *Moss* v. *Lane Co.*, 471 F.2d 853, 855-56 (CA4)."

I find, therefore, that the class as modified may succeed to the adversary position of the named representatives. The defendant's motion for judgment notwithstanding the verdict on the basis is denied.

Liability of Accountants as Aiders and Abettors

Louis Sternbach & Co. was found liable to the plaintiff class as an aider and abettor of the primary security law violation. Three essential elements must be proved to establish aiding and abetting liability [*IIT, An International Investment Trust* v. *Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980)]:

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"(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party;

(2) 'knowledge' of this violation on the part of the aider and abettor; and

(3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation. [Citations omitted]."

With regard to the existence of the primary violation, the defendant Sternbach contends that the original figures in the financial statements were accurate and contests the validity of the Price Waterhouse Reports. Although Sternbach points out that these documents were admitted into evidence against the Solitron defendants only, they did form the basis of establishing the primary violation. The jury found that the Solitron defendants had violated Rule 10b-5 . This Court has determined that there was sufficient evidence to support their determination to withstand the defendants' judgment n.o.v. motions. The first element, the violation of the securities law by the primary party, has been proved.

Defendant Sternbach argues that its actions in connection with the financial statements do not constitute substantial assistance. Defendant contends that mere inaction or a failure to disclose cannot be regarded as substantial assistance. Sternbach audited the books and records of Solitron and certified the financials for its Annual Report to shareholders. This does not constitute mere inaction. If this was done with actual knowledge of the primary fraud, I think it would be sufficient to establish substantial assistance. This need not be decided, however, because I find that there was no proof at trial from which reasonable jurors acting reasonably could conclude that Sternbach acted with scienter.

In order to prove that an aider and abettor acted with scienter, plaintiffs were required to prove that the accountants rendered

substantial assistance with actual knowledge of the primary fraud. *Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); *accord, IIT, An International Investment Trust* v. *Cornfeld, supra.* Proof of negligence is insufficient. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1978). Although this Circuit has held that proof of recklessness will suffice when the aider and abettor owes a fiduciary duty to plaintiff, *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), no argument has been made that the accountants owed a fiduciary duty to the plaintiff investors. See also, *Competitive Associates, Inc.* v. *Laventhol Krekstein Horwath & Horwath*, 478 F.Supp. 1328, 1342 (S.D.N.Y. 1979).

The Court finds insufficient evidence in the record to establish that the defendant Sternbach acted with actual knowledge of the primary security violations. Plaintiff argues first that Mr. Cole, a partner of Sternbach & Co., knew that the AEL transaction was a consignment, and yet certified the financial statements which included it as a sale. As evidence thereof, they point to the letter of May 7, 1970 addressed to Mr. Cole and sent by Gideon Dor of AEL Israel setting forth his understanding of the arrangement between the two parties. Cole testified that the letter did not correspond to his understanding of the relationship between the parties. There was no proof of knowledge. Each of the individual defendants denied knowledge that the transactions were consignments and the position of the defendant Solitron, in its own documents and those prepared for Sternbach, indicated that Solitron management characterized this transaction as a sale. Plaintiffs also argue that the jury could infer that Sternbach had knowledge that the AEL Israel, Best & Raynor, and JFD Electronics transactions were consignments because no confirmations were received by Sternbach when requested, no payments were made, no purchase orders were produced, and shipments were

made close to the end of the fiscal year. Assuming the validity of plaintiffs' contentions and that Sternbach should have been put on notice of the irregularity and should have obtained independent evidentiary proof rather than relying on management, all that would be proven is that the defendant acted negligently. An inference from these facts that the defendant Sternbach must have been aware that the sales were actually consignments and that the financials were therefore misleading is not permissible. See *McLean* v. *Alexander*, 599 F.2d 1190, 1199 (3d Cir. 1979).

With respect to the valuation of inventory, plaintiffs point to the fact that the accountants testified that standard accounting procedures were followed but that there was no independent evidence in the work papers. Their argument is that if the plaintiffs followed the proper accounting procedures, they knew of the fraud. Alternatively, they argue that if they did not follow the procedures set out in their own programs, they knowingly certified documents without any knowledge of their truth or falsity. The plaintiffs argument cannot succeed. In whatever terms it is couched, the plaintiffs are essentially arguing that there were mistakes in the financial statements and that if Sternbach had performed its auditing and accounting functions properly, the errors would have been revealed. This does not equal knowing assistance of a fraud. It may constitute negligence and if extreme enough, recklessness, but it does not satisfy the scienter requirement of Rule 10b-5. The jury may not infer that the accountants acted knowingly merely from the presence of the incorrect figures. See *Jacobson* v. *Peat, Marwick, Mitchell & Co.*, 445 F.Supp. 518, 523 (S.D.N.Y. 1977).

There was overwhelming uncontroverted evidence in favor of the defendant Sternbach. There was no evidence from which a reasonable juror acting reasonably could conclude that Sternbach

aided and abetted the primary securities law violation with the requisite scienter. Judgment notwithstanding the verdict is granted to defendant Sternbach on this claim.

NEGLIGENCE OF DEFENDANT STERNBACH.

The jury also received a pendent claim under New York law alleging negligence by the accountants and returned a verdict on this claim for the plaintiff class against Sternbach. Sternbach now moves to set aside this verdict because there was insufficient proof of negligence to sustain the verdict and because plaintiffs, by virtue of their relationship with the negligent actor, or perhaps more properly, their lack of relationship, are not entitled to recover under New York law.

The jury was charged that plaintiff must prove that Sternbach failed to exercise the degree of care which a reasonably prudent accountant would exercise in the same circumstances, that the negligent statements inflated the market price of Solitron and were therefore the proximate cause of damage to the plaintiff class (Tr. 1602-03). The jury found that the accountants had acted negligently in certifying the financial statements of Solitron for the years 1967, 1968 and 1970. If this Court had been acting as trier of the facts, it would have determined the issue of negligence otherwise.

The function of a certified public accountant generally is to examine the books and records, contracts and relevant papers of the client and express an opinion as to whether its financial statements being certified fairly reflect the financial status of the corporation and its operations as of the period certified, and also to determine whether the accounting facts are stated accurately and in compliance with generally accepted accounting principles consistently applied. While it is always hoped that certified public accountants, in connection with their audits, will detect mistakes, frauds, embezzlements or other forms of crookedness in the

company, as this Court has previously observed "no sheriff can prevent all felonies in his bailiwick, and the law does not so require." *Rich* v. *New York Stock Exchange*, 379 F. Supp. 1122 (S.D.N.Y. 1974), *rev'd. other grounds*, 522 F.2d 153 (2d Cir. 1975).

Some evidence of failure to follow standard auditing practices was introduced to the jury. Whether the accountants acted negligently was a question of fact upon which reasonable persons could differ. It was within the jury's function to determine these facts. There was not such a failure of proof to require a judgment notwithstanding the verdict, or a new trial on this point. I decline to disturb the jury's findings of fact.

However, for the reasons stated below, I conclude that judgment must be entered for defendant on this claim as a matter of law.

Plaintiffs are not parties who under New York law are entitled to recover damages from Sternbach because of its negligent representations found in Solitron's certified financials. A plaintiff may never recover for negligence unless the defendant owes that plaintiff a duty to use reasonable care. In the seminal New York case dealing with the liability of accountants to third parties, *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 183 (1931), the New York Court of Appeals declined to extend the auditor's duty owed to its employer under its contract of employment to a plaintiff who loaned the audited company money in reliance on the certified balance sheet, although the defendant knew the balance sheet would be shown to prospective creditors and had, in fact, furnished the company 32 certified copies to be handed out to lenders and suppliers. The Court stressed that the accountants did not know the plaintiff was a specific company to whom the balance sheet would be shown. The Court held, therefore, that the accountants owed no duty, absent fraud,[1] to "the indeterminate class of persons who, presently or in the future, might deal with

the [audited] company in reliance on the audit." The rationale was that this expansion of the concept of duty would expose the accountants to limitless liability.

> "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." 255 N.Y. at 179-80.

That decision did not preclude recovery by all third party plaintiffs in similar situations. The *Ultramares* Court distinguished *Glanzer* v. *Shepard*, 233 N.Y. 236 (1922) which had allowed a buyer to recover from a defendant who negligently certified the weight of goods sold. The Court concluded that the law imposed a duty toward the plaintiff buyer because the defendant public weigher had been made aware that the certificate was prepared for plaintiff's sole benefit, and had furnished it directly to the plaintiff. The law of New York, therefore, appeared to impose a duty to use reasonable care only when the third party and the certificate's intended use were identified. Otherwise, the duty to use care was limited to those entitled by contract or privity.

In *White* v. *Guarente*, 43 N.Y.2d 356, 361 (1977), the New York Court of Appeals most recent pronouncement on accountants' liability to third parties, that Court extended the accountants' duty to a known and settled group whom the accountant "must have known . . . would necessarily rely on or make use of the audit." The Court cited *Glanzer* and held that this duty was imposed by law and not limited by contract or privity. *Id.* at 362.

While *Ganzer* had held that a plaintiff whose reliance was specifically foreseen could recover, *White* extended this concept to permit recovery by members of a limited class whose reliance should have been foreseen. Plaintiff, one of twenty limited partners was therefore permitted to recover from the accountants who were hired by the general partners to audit the books and prepare the partnership tax returns, "not as a mere member of the public, but as one of a settled and particularized class among the members of which the report would be circulated for the specific purpose of fulfilling the limited partnership agreed upon arrangement." *Id.* at 363.

In the instant case, plaintiffs, as an amorphous group of those who traded in the public securities market during the years at issue, were not members of a "settled and particularized class" when the financial statements were certified. Their individual and collective identity was unknown to Sternbach. Although the defendants knew that investors would rely on the financial statements, the group of potential investors was and is almost as widespread as the general public. Although the *White* Court may have expanded the scope of accountants' negligence liability, it distinguished but did not overrule *Ultramares*. We do not agree with plaintiffs that the rationale and policy and considerations supporting *Ultramares* have so changed with time, that the New York Court of Appeals would overrule that decision if presented with these facts today. But see *Dworman* v. *Arthur Andersen & Co.*, N.Y.L.J., May 1, 1980 (Sup.Ct., N.Y. Co.). Plaintiffs are plainly within the proscriptions of the *White* decision.

> "Indeed, the import of Ultramares is its holding that an accountant need not respond in negligence to those in the extensive and indeterminable investing public-at-large." *White* v. *Guarente*, 43 N.Y.2d at 361.

Judgment notwithstanding the verdict is entered for defendant Sternbach on the negligence or professional malpractice claim, solely as a matter of law.

2. *Second Sub-Class.*

The second sub-class consists of investors who purchased Solitron stock during the period extending from June 8, 1972 to January 27, 1975. Their Rule 10b-5 claim, asserted only against the Solitron defendants, was based on the Solitron Annual Reports for the fiscal years ending 1972, 1973 and 1974. Plaintiffs allege that the statements in these Reports were materially false and misleading because they failed to disclose the *amount* of excess profits assessed by the Renegotiation Board.

The facts on which this claim is based are undisputed. Solitron received notification in 1972 that the Renegotiation Board had determined that it owed $3,200,000 in excess profits for fiscal year ending February 28, 1967 and $4,400,000 attributable to the fiscal year ending February 28, 1968. In its Annual Reports for fiscal years 1972, 1973 and 1974, Solitron disclosed the fact that liability assessments had been rendered, mentioned no amounts, and informed the reader that management was contesting the assessment, and believed no significant refund would be required when the matter was fully adjudicated. See p. 4, *supra*. The jury returned a verdict for the plaintiff class and determined that this failure to disclose had inflated the market price of Solitron shares by 28.2 cents per share.

The defendants now move to set aside the verdict. Defendants argue that there was no duty to disclose the precise amount of the claim and that no material fact was withheld from the investing public.

The only proof offered by plaintiffs in support of this claim was the assessments rendered by the Renegotiation Board, the receipt of this information by Trager, and the failure to disclose the precise amount of the assessment.

Solitron management never for one moment believed that the Renegotiation claim asserted by the Government had any merit, or presented any real risk of loss to the corporation. They knew that income and profits of Solitron, together with its sales and inventory, had been materially overstated during the years 1967 through 1970. To demonstrate this fact, they commissioned the making of the Price Waterhouse Reports. As had been noted in our discussion of the claim asserted by the first sub-class based on the misrepresentations in the financial statements for those years, defendants knew exactly where to look to find the information to support the Price Waterhouse Reports. Price Waterhouse did not conduct an *audit* of the books and records of Solitron for the prior years. It merely compiled a *report* from materials furnished by management which tended to demonstrate that there were no excess profits.

The federal securities laws do not require management to "disclose" in its public reports, facts or information which are conjectural, speculative, or which management itself does not reasonably believe to be true. In the circumstances of this case, defendants reasonably believed that the "box car numbers" attached to the Government's tentative Renegotiation assessment were so unfounded as to be immaterial and absurd.

Solitron management here disclosed truthfully to the public, and to the shareholders that such claim was outstanding, that they were resisting the claim, and that they did not regard it as having any material effect. To handle the claim, they retained Mr. Alexander Kirk, who had previously disposed of a similar claim made against a Solitron subsidiary by the Renegotiation Board in a manner satisfactory to management. Although Kirk

was not a lawyer, the Court concludes that he understood Renegotiation claims and had been effective over many years in representing clients in resisting such claims. Mr. Kirk advised management in writing in effect that the claims had no merit, in his professional judgment.

Any juror acting reasonably should have concluded that Solitron management reasonably believed Kirk's conclusions and opinions on the point. Disclosure was adequate.

If more is to be said about the Renegotiation claims, we observe that Solitron was first notified of the assessments in 1972. As of the date of trial, and for all this Court knows at the present date, although involving a rather substantial amount of money, the claims have never been resolved. This gives rise to two possible conflicting inferences. The first is that the Executive Branch of the United States Government does not know what it's doing, is extremely inefficient, and cannot even collect a claim against Solitron for sums in excess of Seven Million Dollars going back to 1967 and 1968, and pending administrative resolution since 1972. An equally possible inference, slightly more charitable, is that the bureaucrats who asserted this federal claim against Solitron know perfectly well that it has no merit, and for that reason they have not pursued it. We like to think that our Government functionaries are sincerely motivated, are honest, and pursue valid claims against citizens and taxpayers in favor of the Government, or at least claims they consider valid. When claims in large dollar amounts such as these are allowed to slumber for almost a decade, that fact suggests that the Renegotiation claims have no merit, and indeed that those charged with the duty to pursue the claims know that they have no merit, but are too timid to put their chop on a paper withdrawing the claims.

For all of these reasons, this Court is convinced that no reasonable juror, acting reasonably, could find a violation of Rule 10b-5,

or any other relevant statute or rule of law in connection with Solitron's reporting to its shareholders of facts concerning its outstanding Renegotiation claims.

The motions of Solitron, Trager, Barry and Friedman for judgment notwithstanding the verdict is granted, so far as it pertains to the claims of the second sub-class. The motion of Sternbach for judgment notwithstanding the verdict is granted on both claims. In all other respects, the motions are denied.

CROSS-CLAIMS AND DEMANDS FOR INDEMNITY AND CONTRIBUTION.

The cross-claims of the defendants were reserved to the Court at trial. (Tr. 1644-45). The Court has not yet received a full submission of these claims. It would seem, however, that the Court's analysis of the motions for judgment n.o.v. suggests that there is no basis for granting any contribution or indemnity to any party seeking such relief.

Sternbach, because of its negligence as found by the jury should not be entitled to indemnity from Solitron for the costs of defense of this lawsuit. Solitron is not entitled to any indemnification or contribution from Sternbach, because the fraud took place at a high level in Solitron management, and is therefore imputed to the corporation. Neither the corporation, nor its officers, nor the individual defendants were relying on Sternbach in the matter. In point of fact, Sternbach was gulled by false representations made to it by Solitron. As between an intentional wrongdoer, Solitron, on the one hand, and a negligent wrongdoer, Sternbach, on the other, this Court perceives no basis for indemnity or contribution. Recognizing that counsel has not yet been given the opportunity to make further submissions which were promised, unless some aspect of the issues relating to the cross-claims has been omitted from consideration by the Court, the Court is prepared to regard them as properly denied.

Memorandum and Order of the District Court Granting Sternbach's Motion for Judgment Notwithstanding the Verdict

Settle an interlocutory judgment on five (5) days notice of settlement, or preferably on waiver of notice. The judgment shall adjudicate the rights of the named parties and shall adjudicate also the rights of the absent class members, reserving jurisdiction for the purpose of processing claim forms and hearing objections to such claims, if any, and also to fix and allow legal fees and disbursements out of the class recovery. Upon the entry of that judgment the Court will, if so requested, consider whether all or part of the issues therein resolved should be certified for an interlocutory appeal pursuant to 28 U.S.C. § 1292(b).

So Ordered.

Dated: New York, New York
March 6, 1981

CHARLES L. BRIEANT

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Charles L. Brieant
U. S. D. J.

Memorandum and Order of the District Court Granting Sternbach's Motion for Judgment Notwithstanding the Verdict

FOOTNOTES

1. The amended complaint also pleaded pendent claims of common law fraud which the Court dismissed. (Tr. 1415).

2. As originally certified, the plaintiff class was divided into three sub-classes. See, Memorandum Decision, February 13, 1979. The claims of the third sub-class were based upon claimed misrepresentations and/or omissions in the financial statements for fiscal year ending February 1971. Plaintiffs abandoned this claim at trial for want of proof and therefore it was not submitted to the jury. (Tr. 1435).

3. This sub-class originally included persons who had purchased Solitron shares during the period extending to June 2, 1971. At the close of trial, the parties stipulated that the first class would close on December 16, 1970, two days after the press release which disclosed the write-offs Solitron was going to make. (Tr. 1517-18).

4. Defendants do argue that the major portion of the disparity between the original financials and the later "accurate" figures was attributable to ordinary error, resolved after the event by Solitron's later acquired computer capability and a subsequent time and motion study used to verify inventory costs. They contend that the remaining amount is not material. The factual issues, discussed *infra*, were resolved by the jury, adversely to defendants.

5. Defendants argued that historical price/earnings ratio has little to do with the market price of stock of a publicly traded company. Mr. Richard Rogalski testified that the approach used by Mr. Gorkiewicz was wrong. He analyzed the market price of Solitron throughout the applicable period using "efficient market approach" which assumes that publically available information is reflected in the market price. By using this approach and comparing the fluctuations in price for Solitron with similar companies in the industry and with a broad based market index, he concluded that the overstatements in inventory and the disclosure of the inventory write-down in December 1970 had no impact on the financial "return" of Solitron.

A large section of the financial press and the investing public do appear to pay attention to the historical earnings of a company and believe they are reflected in the current prices of stocks. Investment literature usually contains this information and it is readily available in the daily financial papers. It is a common belief that, all other things being equal, if earnings increase, the price of the stock will increase. While sophisticated investors might reject this theory as unproven, and still other such investors believe one can select the best investments by treating the entire exchange listing of publicly traded stocks as a dartboard, the jury could find that the overinflated earnings were a material misrepresentation to the investing public at large which affected price directly. If an investor made a decision to invest at an

asking price on the basis of earnings that were wilfully inflated, the market would be polluted. Investors were entitled to rely on a market in receipt of all relevant material and truthful information. It is too late to argue that historical earnings reported do not affect stock prices, and are therefore not "material" to investment decisions, valid though the argument might be in a market where all buyers are experts. And it is also too late to contend that market pollution of this sort cannot be regarded by a jury as the proximate cause of financial loss.

6. Plaintiffs originally requested certification of a class that would include purchasers to and including June 15, 1971, a period two weeks after the publication of the Solitron Annual Report. The court determined that the period required by the public marketplace to absorb fully the contents of the reports was not that long and the period was shortened to two days.

7. The *Ultramares* Court recognized that third parties could recover from accountants when the cause of action was based on fraud, rather than mere negligence. In *State Street Trust Co.* v. *Ernst*, 278 N.Y. 104 (1938), the Court held that third parties could prove fraud by demonstrating "heedlessness and reckless disregard of consequences," rather than deliberate intention. Such heedlessness and reckless disregard was not proved as to Sternbach.

Judgment of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369 (CLB)

HOWARD SIROTA,

Plaintiff,

—against—

SOLITRON DEVICES, INC., et al.,

Defendants.

JUDGMENT

WHEREAS:

This is a consolidated class action brought on behalf of certain purchasers of stock of Solitron Devices Inc. against Solitron Devices Inc., Benjamin Friedman, James P. Barry and James S. Trager and Louis Sternbach & Co.

This action was tried to a jury which returned a general verdict for the plaintiff class, and also answered special interrogatories with respect to liability and damages, pursuant to Rule 49(b) Federal Rules of Civil Procedure.

Defendants Solitron, Friedman, Barry and Trager moved for a judgment n.o.v., pursuant to Rule 50(b), Fed. Rules Civ. Procedure, or in the alternative for a new trial pursuant to Rule 59(a) Fed. Rules Civ. Procedure. Defendant Sternbach also moved for judgment n.o.v. as well as for an Order granting it contribution over on its cross-claims against Solitron, Friedman, Barry and Trager. Defendants' motions have been briefed and argued

before this Court and the Court rendered a decision on March 6, 1981 with respect to defendants' motions, granting them in part and denying them in part.

IT IS HEREBY ORDERED AND ADJUDGED:

1. That defendants Solitron, Friedman, Trager and Barry's motions for judgment n.o.v., or in the alternate for a new trial as to the jury verdict of liability and damages with regard to plaintiffs' claims concerning misrepresentations of inventory, sales and profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970 are hereby denied, and these defendants are hereby adjudged to be liable jointly and severally for the damages set forth below as a percentage of inflation of the purchase price to any purchaser of the common stock of Solitron Devices, Inc. who purchased during the following time periods and either retained or sold said stock after December 16, 1970, except that defendant Barry is adjudged to be liable only with respect to the period May 27, 1970 and through December 16, 1970:

Period of Overstatement	*Percentage of Inflation*
May 5, 1967-June 5, 1968	33%
June 6, 1968-May 27, 1969	54.2%
May 27, 1970-Dec. 16, 1970	52.2%

plus pre-judgment interest from the date of purchase at 6% per annum and for a joint bill of costs to be taxed by plaintiffs against the above defendants only. However, the recovery of any purchaser, exclusive of interest, shall not exceed the actual loss of that purchaser based on the market price of Solitron stock on October 31, 1979, that being the date on which the class was

closed and following which no opt-out was authorized, or the actual loss based on actual selling price of the stock if sold prior to October 31, 1979.

2. That defendant Sternbach's motion for judgment n.o.v. as to the jury verdict of liability and damages against defendant Sternbach under Rule 10b-5 and for negligent misrepresentation with regard to plaintiffs' claims concerning misrepresentations of inventory, sales and therefore profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970 is granted, and it is adjudged that all relief shall be denied as against defendant Louis Sternbach & Co., without costs to any party.

3. That the motions of defendants Solitron, Friedman, Trager and Barry for judgment n.o.v. as to the jury's verdict of liability and damages with regard to plaintiffs' claims concerning Solitron's failure to disclose in the financial statements for the fiscal years ending February 28, 1972, February 28, 1973 and February 28, 1974, the amount of contingent liability which had been determined by the United States Renegotiation Board to be owed by Solitron is hereby granted without costs to any party.

4. That all cross-claims and demands for indemnity and contribution among and between the defendants are hereby denied without costs to any party.

5. The Court hereby reserves jurisdiction over all matters relating to the administration and processing of class members' objections to such claim forms, including without limitation, the hearing of objections to such claims, and fixing and allowing counsel fees and expenses out of the class recovery and the entry of any further judgment or judgments as may be necessary to effect and enforce the rights of the parties.

Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 158, 310, 476—August Term, 1981

(Argued: November 9, 1981 Decided: February 19, 1982)

Docket Nos. 81-7357, 81-7367, 81-7377

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,
Plaintiff-Intervenor-Appellant,

—against—

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,
Defendants-Appellants-Cross-Appellees,

and

LOUIS STERNBACH & CO.,
Defendant-Cross-Appellee.

Before:

LUMBARD, OAKES and KEARSE, *Circuit Judges*

Appeal from that part of an order of the United States District Court for the Southern District of New York, Charles L. Brieant, Jr., *Judge*, denying judgment notwithstanding the verdict to defendants-appellants-cross-appellees, who were found liable for

damages for violating section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5; cross-appeal from that part of the order granting judgment notwithstanding the verdict to defendants-appellants-cross-appellees and to defendant-cross-appellee for certain securities law violations. Judgment affirmed on the appeal; reversed as to defendant-cross-appellee only on the cross-appeal; and remanded for redetermination of damages and contribution.

PAUL WINDELS, JR., Windels, Marx, Davies & Ives (Andrew N. Grass, Jr. and Mitchell L. Marinello, of counsel), New York, N.Y., *for Defendants-Appellants-Cross-Appellees.*

I. STEPHEN RABIN, Rabin & Silverman (Benedict Wolf, Stephen D. Oestreich, Wolf Popper Ross Wolf & Jones, and Allan K. Peckel), New York, N.Y., *for Plaintiffs-Appellees-Cross-Appellants.*

ROBERT E. MESHEL, D'Amato & Lynch (John M. Burns, III, of counsel), New York, N.Y., *for Defendant-Cross-Appellee.*

OAKES, *Circuit Judge:*

This securities class action was tried on the theory that Solitron Devices, Inc. (Solitron), and certain of its officers, aided and abetted by its accountants, Louis Sternbach & Co. (Sternbach), intentionally issued annual reports and financial statements containing materially false misrepresentations of the company's sales, income, and inventories. The plaintiff class, purchasers of Solitron shares on the public market (the American Stock Exchange), received a general verdict and favorable answers to special interrogatories from a jury in the United States District Court for the Southern District of New York, before Charles L. Brieant, Jr., Judge.

Opinion of the United States Court of Appeals for the Second Circuit

The Solitron defendants appeal from the court's denial of their motion to decertify the class, made on the ground that the named representatives had purchased their shares after the date stipulated as the closing date for their subclass; from the court's decision not to set aside the verdict against them with respect to fiscal year-end financial statements for 1967, 1968, and 1970; from the amount of damages; and from the court's exclusion of certain proffered testimony. The plaintiffs cross-appeal from the court's decision to set aside the verdict against the Solitron defendants with respect to fiscal year-end financial statements for 1972, 1973, and 1974; and from the court's decision to set aside the verdict against Sternbach with respect to the 1967, 1968, and 1970 reports. We reverse the damage award and the decision to grant judgment in Sternbach's favor notwithstanding the verdict, and remand for redetermination of damages and determination of the amount of contribution owed Sternbach by the Solitron defendants.

I. FACTS

Solitron, a manufacturer of electronic semi-conductors, was subject by virtue of its contracts with the United States government to the Renegotiation Act of 1951, as amended, 50 U.S.C. App. §§ 1211-1233. In 1972 the Eastern Regional branch of the United States Renegotiation Board, which enforces the Act's limits on profits from government contracts, determined that Solitron had realized renegotiable profits of $3.2 million in fiscal year 1967 and $4.4 million in fiscal year 1968.

Solitron, seeking administrative review of the Board's assessment, retained Price Waterhouse & Co. to reexamine its financial statements for 1967 through 1970. Price Waterhouse concluded that those statements, prepared and certified by Sternbach and signed by Benjamin Friedman, Solitron's chief executive officer and largest shareholder, had substantially overstated inventories

and sales. In 1973 and 1974 Solitron, seeking to avoid liability for excess profits, disclosed these overstatements to the Renegotiation Board in letters prepared by James S. Trager, a former Sternbach accountant who was then Solitron's assistant treasurer, and James P. Barry, then Solitron's treasurer. In January 1975 the Renegotiation Board issued a final determination that Solitron owed $3.9 million in excess profits from 1967 to 1970, which Solitron is contesting before the Court of Claims. In March 1975 the Securities and Exchange Commission (SEC) brought an action against Solitron for violations of the securities laws, but withdrew the charges the next month pending an investigation by special SEC counsel, who concluded in June 1978 that Solitron had overstated income, but had not done so fraudulently.

Named plaintiffs Howard Sirota (who purchased Solitron shares on June 1, 1971) and Family Restorations (who purchased Solitron shares on April 7, 1971) filed the instant action in March 1975. They contended that the misrepresentations of fact in the company's 1967-70 financial statements that were revealed in the proceedings before the Renegotiation Board demonstrated that defendants Solitron, Friedman, Trager, Barry, and Sternbach had violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. They complained that inventories had been overstated while consignments had been improperly treated as sales, and that Solitron had failed to provide any reserve for probable refunds to the government of renegotiated profits. Their complaint was consolidated with others against Solitron in February 1976.

In February 1976 the named plaintiffs sought certification as representatives of a single class of Solitron investors who purchased common stock during the period beginning February 28, 1967 and ending March 20, 1975, and who thereafter sold at a loss. Subsequently they moved for the designation of three subclass periods: (1) purchased between May 5, 1967 and June 15,

1971 (which included Howard Sirota and Family Restorations); (2) purchasers between June 15, 1971 and June 22, 1972; (3) purchasers between June 22, 1972 and March 20, 1975. The second of these subclasses was dismissed at trial for want of proof of its claims.

The first subclass was originally certified by the court to include purchasers between May 5, 1967 and June 2, 1971, notwithstanding Solitron's argument that its December 14, 1970 press release announcing losses and inventory writedowns of $7 million, which plaintiffs contended was itself fraudulent, had nullified any effect of the alleged misrepresentations on post-December purchasers of Solitron stock. The parties stipulated at the end of trial that the subclass closed on December 16, 1970. The claims of this 1967-70 subclass prevailed before the jury, and the court, refusing to decertify, granted judgment notwithstanding the verdict to Sternbach but not to Solitron, against whom the court upheld the jury's damage award. The third subclass, certified by the court to include purchasers between June 8, 1972 and January 27, 1975, claimed that Solitron's annual reports for 1972-74, which stated that the Renegotiation Board had assessed Solitron's excess profits but failed to disclose the amounts, were materially false and misleading. Although this subclass also prevailed before the jury, the court granted judgment to the Solitron defendants notwithstanding the verdict.

II. DISCUSSION

A. *Certification of the Class*

The Solitron defendants appeal first from the court's decisions to certify and not to decertify the class represented by plaintiffs Sirota and Family Restorations. The court certified this subclass on February 13, 1979 to include purchasers of Solitron stock between May 5, 1967 and June 2, 1971 (two days after release of the 1970 annual report). The parties stipulated at the close of

trial, however, that December 16, 1970 (two days after the press release reflecting $7 million dollar inventory write-downs) was the closing date for the class. Family Restorations bought its shares on April 7, 1971; Sirota on June 1, 1971. Thus the named plaintiffs were in the subclass as originally certified but out of it as stipulated. The Solitron defendants argue on appeal that the named plaintiffs were not qualified to represent the class. They argue that the court erred, first by not ruling before certification that the December 1970 press release had cut off any injury to the market or to the named plaintiffs from the 1967, 1968, and 1970 financial reports, and second by not decertifying the class when the plaintiffs rested their case without having shown that the December 1970 press release was fraudulent.

1. *Certification*

Judge Brieant certified the subclass as extending until June 2, 1971 on the ground that precertification "inquiry into the merits of a suit" was barred by *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974). *Eisen* held that Fed. R. Civ. P. 23 gave a district court no authority to hold a precertification hearing on the merits in order to determine whether a suit may be maintained as a class action, and therefore that the lower court's allocation of the costs of class notice to defendants upon a preliminary determination that plaintiffs were "more than likely" to prevail was improper. Class certification motions are not subject to the same standards as motions for dismissal for failure to state a claim or for summary judgment. *See Miller* v. *Mackey International, Inc.*, 452 F.2d 424, 428 (5th Cir. 1971), *cited with approval in Eisen*, 417 U.S. at 178.

On the other hand, there can be no doubt that it is proper for a district court, prior to certification of a class, to allow discovery and to conduct hearings to determine whether the prerequisites of Rule 23 are satisfied. "[A] preliminary hearing, addressed not to

the *merits* of plaintiff's individual claim, but to whether he is asserting a claim, which, *assuming its merits*, will satisfy the requirements of Rule 23, has never been regarded as violative of the rule stated in *Eisen* . . . ." *Doctor* v. *Seaboard Coast Line Railroad Co.*, 540 F.2d 699, 707 (4th Cir. 1976) (emphasis in original) (footnote omitted). Indeed a district court may be reversed for premature certification if it has failed to develop a sufficient evidentiary record from which to conclude that the requirements of numerosity, typicality, commonality of question, and adequacy of representation have been met. *See, e.g., Chateau de Ville Productions, Inc.* v. *Tams-Witmark Music Library, Inc.*, 586 F.2d 962, 966 (2d Cir. 1978).

The issue here falls between the prohibition in *Eisen* and the obligation to rest certification under Rule 23 on something more than the pleadings, *see, e.g., Professional Adjusting Systems of America, Inc.* v. *General Adjustment Bureau, Inc.*, 64 F.R.D. 35, 38 (S.D.N.Y. 1974) (Gurfein, J.) If the Solitron defendants were arguing that a district court must determine whether the named plaintiffs have a meritorious claim before they can be certified as class representatives, they would plainly be wrong. *See, e.g., Huff* v. *N.D. Cass Co.*, 485 F.2d 710, 714 (5th Cir. 1973) (en banc) (vacating dismissal of class action on ground that "a class plaintiff who otherwise meets the demands of 23(a) and (b) should not be found to be disqualified solely by an advance determination that his claim is predictably not a winning claim and that, therefore, he cannot adequately represent the class as mandated by 23(a)(4)"). Solitron's argument may be, rather, that some kinds of merits determinations are crucial to determining whether a class action is proper and that in such circumstances *Eisen* poses no bar.

The dictum in *Huff* did suggest that some very basic merits determinations—*e.g.*, whether a named plaintiff suing his employer was ever employed by the defendant, 485 F.2d at 714—may be made prior to certification because they affect

whether the named representative has the nexus with the class required by Rule 23. But the determination involved here is not so basic. No case cited by Solitron supports the proposition that a district court abuses its discretion by certifying when it later appears that plaintiffs lacked a meritorious cause of action. *Doctor* v. *Seaboard Coast Line Railroad Co.* cites the *Huff* dictum, but only to support the more obvious proposition that the court may properly "identify the character or type (*but not the merits*) of each plaintiff's claim and then . . . determine whether there was a class to which such claim . . . was common and of which it was typical. . . ." 540 F.2d at 708-09 (emphasis in original). In *Doctor* the district court denied class representative status to plaintiffs whose claims were plainly unfit for a class action because they were not shared by any other employees; the court never reached nor thought it proper to reach the merits of the individual claims.

As Judge Gurfein wrote, in making a certification decision, a judge must look somewhere "between the pleading and the fruits of discovery . . . . [E]nough must be laid bare to let the judge survey the factual scene on a kind of sketchy relief map, leaving for later view the myriad of details that cover the terrain." *Professional Adjusting Systems of America, Inc.* v. *General Adjustment Bureau, Inc.*, 64 F.R.D. at 38. On this view, it would be improper for a district court to resolve substantial questions of fact going to the merits when deciding the scope or time limits of the class. Even a case on which the Solitron defendants rely heavily, *In re LTV Securities Litigation*, 88 F.R.D. 134, 147-48 (N.D. Tex. 1980), supports this view. In that case, Judge Higginbotham decided to close the class period on the date of a press release he regarded as cutting off further claims. He also chose the earlier of two suggested dates for opening the class period, however, thus including in the class those who purchased before the first announcement of restated earnings, stating that while "the court has reservations as to whether plaintiff can make out a

claim with regard to the 1975 period, [it] believes that a sufficiently substantial question has been presented such that the class period must commence at the earlier time period proffered." *Id.* at 147. Thus where it was disputed whether part of a proposed class had a cause of action, Judge Higginbotham certified the class using the more inclusive time period.

Here too, the district court may properly have believed at the time of the decision to certify that there was a substantial question of fact for the jury whether the December 1970 press release had cured the market, barring post-December claims, or was itself fraudulent. Solitron's arguments about that release would then have appeared to be defenses on the merits. The parties' post-trial stipulation to a December 16, 1970 closing date for the subclass, even though it mooted the merits of this issue, cannot be applied retroactively to the pretrial decision to certify.[1] We therefore find that it was proper for Judge Brieant to certify the class as he did, including post-December claimants within the first subclass and allowing Sirota and Family Restorations to act as class representatives.

2. *Decertification*

Although a district court may decertify a class if it appears that the requirements of Rule 23 are not in fact met, it need not decertify whenever it later appears that the named plaintiffs were not class members or were otherwise inappropriate class representatives. Rather, the Supreme Court has stated, "provided the

1. Judge Brieant stated in colloquy over his jury charges that the named plaintiffs could properly try the case with respect to absent members of the class even though "if hindsight were foresight they shouldn't have been designated as class representatives because of the dates." Plaintiffs argue that they stipulated to the earlier closing date only in order to take out of the case the issue of what damages were sustained by those who purchased Solitron stock between December 16, 1970 and June 2, 1971. It is not now disputed that the named plaintiffs are not themselves entitled to recover as members of the class.

initial certification was proper . . . the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims." *East Texas Motor Freight System, Inc.* v. *Rodriguez*, 431 U.S. 395, 406 n.12 (1977) (citing *Franks* v. *Bowman Transportation Co.*, 424 U.S. 747, 752-57 (1976). Here certification was proper, and there was no need for decertification. But for the parties' stipulation to December 16, 1970 as the closing date, the question of the effect of the press release (and thus the question of the merit of the named plaintiffs' claims) would have been resolved by the jury verdict. The defendants have not shown that the named plaintiffs failed to represent the class adequately, and the class's victory before the jury might be thought to rebut such an argument in any case. Thus the subsequent definition of the class to exclude the individual named plaintiffs did not require decertification of the class.

B. *Sufficiency of the Evidence*

1. *Fraud by the Solitron Defendants, 1967-70*

The Solitron defendants also appeal from the district court's decision not to set aside the jury's verdict that in the company's financial statements for 1967, 1968, and 1970 they knowingly and materially misrepresented inventories and characterized certain consignments as sales. As the court properly noted, judgment notwithstanding the verdict may be entered only if the evidence, viewed in the light most favorable to the non-movants without considering credibility or weight, reasonably permits only a conclusion in the movants' favor. *Mattivi* v. *South American Marine Corp., "Huguenot"*, 618 F.2d 163, 167 (2d Cir. 1980); *Simblest* v. *Maynard*, 427 F.2d 1, 4 (2d Cir. 1970).

a. *Inventory Overstatements*

It is undisputed that the financial statements for the fiscal years ending 1967, 1968, and 1970 materially overstated inventory. The Solitron defendants argue collectively, however, as they did below to the jury and the court, that the inventory recosting that demonstrated the substantial over-statements was not even possible until Solitron had acquired for the first time a computer capability and a sophisticated inventory costing system based upon newly developed time-and-motion studies recommended by Price Waterhouse in 1972, some two years after the misstatements. They therefore argue that the evidence was insufficient to show scienter, *i.e.*, that there was either actual knowledge of the misrepresentations or a reckless disregard for the representations' truth or falsity. *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *IIT, an International Investment Trust* v. *Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980), *See also Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978), *on appeal from remand*, 637 F.2d 77 (2d Cir. 1980).

We agree with Judge Brieant's post-verdict assessment that there was sufficient evidence of scienter on the part of the company and the individual defendants to sustain the jury verdict against the Solitron defendants for 1967, 1968, and 1970. The jury could properly infer intent from subsequent admissions of misrepresentations, coupled with the defendants' continuous intimate knowledge of company affairs. Solitron benefited from overstating its inventory. From 1966 through 1970 its reported earnings per share surged upward 100%, 50%, 33⅓%, and 20% respectively. The price of the stock followed the reported earnings, enabling Solitron to make numerous acquisitions[2] after a five-for-one split in April 1968. There was direct evidence that

2. These acquisitions included, among others, Felmohn Corp., a manufacturer of microwave devices and electronic instruments; General

Friedman as well as Trager knew that inventory had increased from $1.5 million in 1966 to $2.94 million in 1967, while the inventory-turnover rate declined from 6 times a year to 4.5 times a year; that inventory had increased nearly $5 million in 1968, reducing inventory turnover to less than 2.5 times per year; and that in 1970 inventory had increased by nearly $4 million to $12.5 million, with a turnover rate of only 1.9. The Solitron defendants admitted such overstatements of inventory to the Renegotiation Board in 1974.

There was also direct evidence that accounting procedures at the Riviera Beach, Florida plant, where Solitron carried on its government business, were inadequate to cost inventory accurately. As Barry stated in a letter to renegotiation counsel, the accounting department was "understaffed" and "poorly managed," in keeping with the company's policy at that time: "get the shipment out the back door, get the invoice in the mail to the customer, operate with a minimum overhead, and profits will be generated." Inability to cost certain "highly reliable" and commercial inventory resulted in overstatements in 1967 of $556,000, in 1968 of $1.35 million, and in 1969 of $904,000; there were also raw-material and piece-part costing and other errors of lesser magnitude. Mathematical calculation and addition errors in the year 1968 amounted to $1.05 million.

The evidence of each individual defendant's knowledge of and involvement in the preparation and publication of false financial statements was sufficient to support findings that they each violated Rule 10b-5. Friedman, the head of the company, was in touch with the Florida plant by telephone each day, received regular summaries and reports from the plant, and frequently visited it. He testified at trial that he knew the effect of inventory

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R-F Fittings, a microwave products manufacturer; a microwave chemicals laboratory; an inventory of digital instruments from Honeywell, Inc.; and certain equipment, patents, and inventory from Electronic Standards Corp. of America.

valuation on profits. There was thus evidence from which the jury could have concluded that he was aware of the company's failure to cost its inventory properly.

Trager, who had been employed by Sternbach until 1971 and who had worked on Solitron audits every year from 1964 to 1969, became comptroller of Solitron in the spring of 1969, assistant treasurer in 1970, and treasurer in 1974. He prepared the reports to the Renegotiation Board showing that profits had been inflated because of overvaluation of inventory, and testified that he knew where to look for the evidence of this overvaluation.

Barry, who was liable for 1970 only, spent fifteen years as an accountant in the Intelligence Division of the Internal Revenue Service before joining the Solitron accounting department at Riviera Beach in July 1968. He became head of that accounting department in 1969 and treasurer of Solitron in 1970. He went back to the 1967-70 inventory figures for Riviera Beach and showed the inventory overstatements. His documentation helped Price Waterhouse reach its conclusions about inventory overstatements and helped Trager prepare his reports to the Renegotiation Board. Barry admitted to the Renegotiation Board the inadequacies of the Riviera Beach accounting procedures. His testimony at trial showed that he had not verified the 1970 inventory sheets that he certified as properly costed.

Without the overstatements, not only would the earnings per share have been less during the years 1966 through 1970, but the gradient of earnings growth would have been flatter. Indeed in 1970 there would have been a decline in earnings. There was expert testimony before the jury about the effect that the overstatement of earnings and the gradient of earnings growth have on stock prices generally. Overall, we believe there was substantial evidence to support the jury's verdict that the Solitron defendants all had the necessary scienter; the court's refusal to set aside the verdict was proper.

b. *Consignments Reported as Sales*

The Solitron defendants claim further that there was no evidence they committed fraud in reporting three consignment transactions—with Best & Raynor, JFD Electronics Co., and AEL Israel, Ltd.—as sales. We find Judge Brieant's conclusion to the contrary correct. Trager, in preparation for the Renegotiation Board proceedings, went back to documents that had been in his possession in 1969 and 1970, and showed that the transactions classified as sales had in fact been consignments. Friedman negotiated and signed the written contract with AEL Israel, which was specified as a consignment arrangement in accord with the understanding of the principal officers of AEL. Yet over $700,000 of consignments were carried on the books as sales. Although Friedman said he thought the first draft of the agreement provided that the risk would be on AEL, the jury did not have to credit his testimony that he believed the contract—which he signed and which placed the risk of loss on Solitron—provided for a sale.[3]

2. *Fraud by Sternbach*

On the cross-appeal, the plaintiffs object both to the district court's finding that there was insufficient evidence to support the verdict against Sternbach, and to the court's failure to give the same "recklessness" charge with respect to Sternbach that it gave with respect to the Solitron defendants. The court instructed that actual knowledge by Sternbach of the fraud by Solitron and by the individual defendants was required. The jury found scienter, but the judge set that finding aside. The jury also found, with

3. The Solitron defendants also appeal from the court's refusal to admit testimony by Solitron's counsel in the AEL negotiations, which it claimed would show that Friedman believed the AEL transaction to be a sale. We find no error in the court's decision to exclude this evidence under Fed. R. Evid. 403 for lack of probative value, made after taking an offer of proof.

respect to a pendent state law count, that Sternbach had been negligent, a finding which Judge Brieant set aside and which is not on appeal.

This court has held that proof of reckless conduct meets the requirement of scienter in a section 10(b) claim, *IIT* v. *Cornfeld*, 619 F.2d at 923. For the imposition of aider and abettor liability under section 10(b), however, we have held that recklessness satisfies the scienter requirement where "the alleged aider and abettor owes a fiduciary duty to the defrauded party," *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d at 44. We have not decided whether recklessness is sufficient in the absence of such a relationship. *Id.* at 44 n.9. At least two district court judges have concluded that recklessness may be sufficient, at least in the case of accountants who know or can reasonably foresee that third parties will rely on their audit or opinion letter. *See Oleck* v. *Fischer*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898 (S.D.N.Y. 1979), *aff'd.* 623 F.2d 791 (2d Cir. 1980); *In re Investors Funding Securities Litigation*, 1980 Fed. Sec. L. Rep. (CCH) ¶ 97,763 (S.D.N.Y. 1980).

We have said in dicta in connection with accountants' liability that it is helpful to refer to Judge Goldberg's statement in *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975):

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter.

See Edwards & Hanly v. *Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484-85 (2d Cir. 1979). *See also IIT* v. *Cornfeld*, 619 F.2d at 924-25. The dicta also seem to refer to a sliding scale of intent; Judge Gurfein wrote that "something closer to an actual intent to aid in a fraud" is necessary to find a

person liable for aiding and abetting, absent a fiduciary relationship, than is necessary to find the principal liable. *Edwards & Hanly*, 602 F.2d at 485. *See also IIT* v. *Cornfeld*, 619 F.2d at 925. The evidence here at the least would support a finding that Sternbach's conduct—with respect to mathematical errors, consignments recorded as sales, and inventory overvaluation—was highly reckless. In light of our holding below, however, we need not reach the question whether Sternbach, in view of whatever duty it had to disclose, should have been judged under a recklessness standard.

The court granted judgment to Sternbach notwithstanding the verdict on the count of aiding and abetting Solitron's 10b-5 violation, finding "no evidence from which a reasonable juror acting reasonably could conclude that Sternbach aided and abetted the primary securities law violation with the requisite scienter." The court, interpreting the requisite scienter to be actual knowledge of the fraud since Sternbach did not owe a fiduciary duty to the plaintiff investors, found that the evidence at most showed that Sternbach was negligent. The proof did not show, the court wrote, that Sternbach's partner Edward Cole knew that the Best & Raynor, JFD Electronics, and AEL Israel transactions were consignments, even though "no confirmations were received by Sternbach when requested, no payments were made, no purchase orders were produced and shipments were made close to the end of the fiscal year," and even though a letter from AEL Israel to Cole said the transaction was a consignment. The court found also that even if, as plaintiffs sought to prove, Sternbach performed inadequate and erroneous audits, this did not constitute knowing assistance in the fraudulent overstatement of inventory.

Recalling the stringent standard for granting judgment notwithstanding the verdict, we disagree with the court's conclusion that no reasonable juror could have reached a verdict against Sternbach. First, the court's conclusion that Sternbach lacked actual knowledge is inconsistent with the jury's finding, upheld by

the court on defendants' post-trial motion, that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud. Second, evaluation of Cole's credibility, in the face of evidence suggesting he was on notice that the transactions he certified as sales were consignments, was for the jury, not the court. And in light of Sternbach's claims to have performed various costing procedures and tests on Solitron's 1967-70 inventory, the jury might well have concluded that Sternbach knew that its certification of reports overstating inventory was fraudulent. The combination of these facts leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach had actual knowledge of fraud in violation of Rule 10b-5.

3. *Fraud by the Solitron Defendants, 1972-74*

On the cross-appeal, plaintiffs also argued that the district court erred in finding that there was no evidence to support the verdict against the Solitron defendants with respect to the financial statements for 1972-74. While these financial statements stated that the Renegotiation Board had determined that Solitron had made excess profits, they did not state that the amounts involved were $3.2 million for the fiscal year ending February 28, 1967 and $4.4 million for the fiscal year ending February 28, 1968. They stated only that the company was contesting the determinations and that management believed that no significant refunds would be required after renegotiation. Plaintiffs argued below that these statements were materially misleading to investors because they suggested that the renegotiation proceedings had minimal significance.

The judge overturned the jury verdict in plaintiffs' favor because he found that the evidence did not support any conclusion other than that Solitron management, which never believed that

the renegotiation assessment was meritorious, had truthfully disclosed to the public. The defendants knew from the Price Waterhouse reports, which they themselves commissioned, that Solitron inventory and income had been materially overstated; they therefore believed that there were no excess profits. Their renegotiation representative, Alexander Kirk, had advised them that the renegotiation assessment had no merit.

While we find in reviewing the record that the question is a close one, we do not think the court erred in setting aside the verdict on this count. There was considerable evidence supporting the view that the defendants reasonably believed that the "box car" numbers used in the government's tentative renegotiation assessment were truly unfounded. The court also noted that to this date the renegotiation claims have never been resolved, suggesting that the government either is extremely inefficient or agrees that the renegotiation claims have no merit. Plaintiffs presented no particular evidence to rebut the defendants' view, but merely argued that the Solitron defendants would not have made the reports they did to the Renegotiation Board unless they expected to be held liable. It is more plausible, however, to infer that they made the reports in the expectation of avoiding liability, in which case their statements to the public were not misleading.

C. *Damages*

Expert witness Gorkiewicz testified for the plaintiffs that when earnings per share were corrected for overvaluation of inventory and sales, Solitron shares were overpriced by 44% in 1967, 72.1% in 1968, not at all in 1969, and 69.6% in 1970. The court submitted to the jury special interrogatory 6a as follows:

State the percentage, if any, by which you find false or misleading financial statements inflated the market price of Solitron stock.

Period of Overstatement, if any	Financial Statements For Year Ending	Percentage of Inflation, If Any
5/ 5/67 - 6/ 5/68	2/27/67	_____
6/ 6/68 - 5/22/69	2/27/68	_____
5/27/70 - 6/ 2/71	2/28/70	_____

The jury responded by filling in for each of the above three periods, respectively, 33%, 54.2% and 52.2%. The judgment entered on April 9, 1981 limited recovery by the members of the class by stating:

> However, the recovery of any purchaser, exclusive of interest, shall not exceed the actual loss of that purchaser based on the market price of Solitron stock on October 31, 1979, that being the date on which the class was closed and following which no opt-out was authorized, or the actual loss based on actual selling price of the stock if sold prior to October 31, 1979.

All parties are agreed that the cut-off date of October 31, 1979 is wrong and that the cut-off date for opting out is irrelevant. The date should be December 16, 1970, when the defendants ceased the "pollution" of the market place. *Harris* v. *American Investment Co.*, 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). Thus the plaintiffs are precluded from claiming a larger award based on declines in price after that date and the defendants from awarding a smaller amount based on increases in price thereafter. *See Voege* v. *Ackerman*, 364 F. Supp. 72 (S.D.N.Y. 1973).

The Solitron defendants argue that plaintiffs' damage theory is illogical and has no support in this circuit because it does not relate the alleged overpricing either to actual market behavior or

to disclosure events, and because it treats the stock as overvalued by a constant percentage for each year. But as the district court pointed out, the year-long periods presented to the jury in Special Interrogatory 6a were stipulated to be accurate time periods, corresponding to the figures outlined by Gorkiewicz. And while it seems odd that the calculations are for full years and vary sharply from the last day of one to the first day of the next, these are only hypothetical constructs which had to be made rather arbitrarily since there were no disclosures until December 1970. Each year was an era and the point in time between years an epoch.

We agree with the court below that with respect to 1967 and 1968, the damage question was one of fact, resolved satisfactorily by the jury through 25% reductions in Gorkiewicz's estimates. But we think that the Solitron defendants are correct that the jury's finding that the stock was overvalued by 52.2% in 1970 cannot stand. After the December 1970 disclosure of the inventory write-downs, the market in the stock declined immediately only 11% and then rose. This actual response of the market must be taken into account in determining the damages for all or part of the year 1970. *See Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC* v. *Texas Gulf Sulphur Co.* 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). This is a matter we leave to the sound discretion of the trial judge, because there might have been other favorable developments in the company or in the market place offsetting the harmful effects of the disclosure.

Solitron also argues that the district court erred because it failed to consider the drastic market decline of 1970, citing *Rolf* v. *Blyth, Eastman Dillon & Co.* and *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F. supp. 544, 586 (E.D.N.Y. 1971). But these cases and the rule they announced have no bearing in a case like this in which a stock purchaser has purchased his stock at a price higher than he would have paid had true financial

statements been made. *Rolf* involved the decline in value of a portfolio of one investor improperly advised by an investment adviser who was recklessly aided and abetted by the investor's broker. *Feit* involved a fraudulent registration statement suit under section 11, with statutorily determined damages expressly excluding damages caused by "independent forces," 332 F. Supp. at 586. Here the issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in the market had no effect on the fraudulent sale.

D. *Contribution*

Sternbach argues that if liable, it is entitled to contribution from the Solitron defendants. We agree. Courts in this circuit have permitted contribution in section 10(b) cases even though section 10 of the Securities Exchange Act, unlike sections 9 and 18, does not expressly provide therefor. *See Tucker* v. *Arthur Anderson & Co.*, 646 F.2d 721, 727 n.7 (2d Cir. 1981); *Seymour* v. *Bache & Co.*, 502 F. Supp. 115, 119 (S.D.N.Y. 1980); *Alexander & Baldwin, Inc.* v. *Peat, Marwick, Mitchell & Co.*, 385 F. Supp. 230 (S.D.N.Y. 1974); *Globus, Inc. v. Law Research Service, Inc.*, 318 F. Supp. 955, 958 (S.D.N.Y. 1970), *aff'd*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971). In *Tucker*, a section 10(b) case, this court noted that "under the securities laws, a person who has defrauded the plaintiff in violation of those laws may be liable for contribution to another person who has similarly defrauded the plaintiff." 646 F.2d at 727 n.7. The amount of contribution we leave to the sound discretion of the trial judge.

Judgment affirmed in part, reversed in part, and remanded.

Judgment of the Second Circuit

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
#81-7357, 7367, 7377

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the nineteenth day of February one thousand nine hundred and eighty-two.

Present:

HON. J. EDWARD LUMBARD,
HON. JAMES L. OAKES,
HON AMALYA L. KEARSE,
Circuit Judges.

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,
Plaintiff-Intervenor-Appellant,

v.

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,
Defendants-Appellants-Cross-Appellees,

LOUIS STERNBACH & CO.,
Defendant-Cross-Appellee,

Judgment of the Second Circuit

Appeal from the United States District Court
for the Southern District of New York

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part, reversed in part and the action be and it hereby is remanded to said district court for further proceedings in accordance with the opinion of this court.

A. Daniel Fusaro, *Clerk*
by S/ ARTHUR HELLER
Arthur Heller,
Deputy Clerk

Orders of the United States Court of Appeals for the Second Circuit on Petitions for Rehearing

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 81-7357
81-7367
81-7377

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the thirteenth day of May, one thousand nine hundred and eighty-two.

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,
Plaintiff-Intervenor-Appellant,

—against—

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,
Defendants-Appellants-Cross-Appellees,

and

LOUIS STERNBACH & CO.,
Defendant-Cross-Appellee.

Petition for Rehearing

Petitions for rehearing containing suggestions that the action be reheard in banc having been filed herein by counsel for the defendant-cross-appellee, Louis Sternbach & Co., and by counsel

for the defendants-appellants-cross-appellees, Solitron Devices, Inc., Benjamin Friedman, James S. Trager and James P. Barry, and the panel that heard the appeal having ordered that the opinion filed February 19, 1982, be amended,

Upon consideration by the panel that heard the appeal, it is

ORDERED that the said petitions for rehearing are DENIED.

It is further noted that the suggestions for rehearing in banc have been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

Filed May 13, 1982.

A. DANIEL FUSARO

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A. Daniel Fusaro
Clerk
by FRANCIS X. GINDHART
Chief Deputy Clerk

Orders of the United States Court of Appeals for the Second Circuit on Petitions for Rehearing

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 81-7357
81-7367
81-7377

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the thirteenth day of May, one thousand nine hundred and eighty-two.

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellees-Appellants,

and

UNION CARBIDE CORPORATION,

Plaintiff-Intervenor-Appellee-Appellant,

v.

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY, and LOUIS STERNBACK & CO.,

Defendants-Appellants-Appellees,

Order on Petition for Rehearing

On petition for rehearing it is hereby ordered that the opinion be amended as follows:

1. Slip op. at 1369, line 24-25, should read: "make several acquisitions.[1] There was direct evidence . . . . "

2. Slip op. at 1369 n.2 should read: "[2] For example, Solitron exchanged approximately 160,000 shares for approximately 800,000 shares of Amphenol Corporation between January and March 1968; acquired Filmohm Corporation in April 1968 for $3.24 million in cash plus 63,100 shares of treasury stock; and acquired Microwave Chemicals Laboratory, Inc., in January 1969 for $91,000 in cash plus 500 shares of treasury stock."

J. EDWARD LUMBARD

J. Edward Lumbard

JAMES L. OAKES

James L. Oakes

AMALYA A. KEARSE

Amalya A. Kearse
Circuit Judges.

Special Interrogatories Submitted to The Jury in the District Court

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369 (CLB)

HOWARD SIROTA, *et. al.*,

Plaintiffs,

against

SOLITRON DEVICES, INC., *et. al.*,

Defendants.

Special Interrogatories

(THE JURY WILL CONSIDER AND ANSWER THE FOLLOWING QUESTIONS IN THE ORDER IN WHICH THEY APPEAR.)

1. Do you find a preponderance of the credible evidence that one or more misrepresentations or omissions were made in connection with the financial statements of Solitron Devices, Inc. for the following years?

	YES	NO
(a) Fiscal year ending February 28, 1967	✓	
(b) Fiscal year ending February 28, 1968	✓	
(c) Fiscal year ending February 28, 1970	✓	
(d) Period including fiscal year ending February 28, 1972 through fiscal year ending February 28, 1974	✓	

(If the answer is YES with regard to the financial statements for any of these years, go on and answer Interrogatory No. 2.

Special Interrogatories Submitted to The Jury in the District Court

Do not answer any further interrogatories with respect to the financial statements if you have answered NO. If you answer NO as to all years, you must enter a general verdict in favor of all defendants on the Rule 10b-5 claim.)

2. As to any year you answered YES in Interrogatory No. 1, was that misrepresentation or omission material, as the Court previously defined that term for you?

	YES	NO
(a) Fiscal year ending February 28, 1967	✓	
(b) Fiscal year ending February 28, 1968	✓	
(c) Fiscal year ending February 28, 1970	✓	
(d) Period including fiscal year ending February 28, 1972 through fiscal year ending February 28, 1974	✓	

(If you answered YES to Interrogatories No. 1 and 2 for any year, go on and answer Interrogatory No. 3 as to any year to which you answered YES. If you answered NO as to all years, skip to Interrogatory No. 5.)

3. If your answer to Interrogatories 1 and 2 is YES with regard to any of the following financial statements, do you find by a preponderance of the evidence that any of the following defendants participated in the preparation and dissemination of them to the public with actual knowledge of their falsity or misleading nature or with a reckless disregard of their truth or falsity?

Special Interrogatories Submitted to The Jury in the District Court

(Answer "Yes" or "No" on each line below.)

Year Ending	Solitron Devices, Inc.	Mr. Friedman	Mr. Barry	Mr. Trager
(i)				
2/28/67	Yes	Yes	not applicable	Yes
2/28/68	Yes	Yes	not applicable	Yes
2/28/70	Yes	Yes	Yes	Yes
(ii)				
2/28/72 through 2/28/74	Yes	Yes	Yes	Yes

If the answer to Interrogatory No. 3 is NO as to all defendants, you will return a verdict in favor of the defendants on this claim and skip to Interrogatory No. 5. If your answer to No. 3 is YES as to any defendants, proceed to Question 4.

4. Do you find from a preponderance of the evidence that the material misstatements or omissions in the financial statements of defendant Solitron Devices, Inc. were the cause of any damages suffered by the plaintiff class?

Answer "YES" or "NO."

Answer: YES

Answer Interrogatory 5 only if you have answered YES to Interrogatories 1, 2, 3 and 4.

5. Do you find by a preponderance of the evidence that Louis Sternbach & Co. knowingly rendered substantial assistance to Solitron Devices, Inc. in violating Rule 10b-5 during the following years?

Special Interrogatories Submitted to The Jury in the District Court

(Answer "YES" or "NO" on each line below.)

Year Ending	
2/28/67	YES
2/28/68	YES
2/28/70	YES

6. Do you find by a preponderance of the evidence that Louis Sternbach & Co. negligently made false representations to market purchasers of Solitron stock, whom they expected to rely upon those representations and who did in fact rely upon them, and that such purchasers were injured as a consequence?

Answer "YES" or "NO".

Answer: YES

Answer 6a if you answered "YES" to Interrogatories 1 and 2 regarding financial statements for the fiscal years ending 1967, 1968 and 1970, and YES to Interrogatory No. 3 or if you answered "YES" to Interrogatory No. 4.

6a. State the percentage, if any, by which you find false or misleading financial statements inflated the market price of Solitron stock.

Period of Overstatement, If Any	Financial Statements For Year Ending	Percentage of Inflation, If Any
5/ 5/67-6/ 5/68	2/27/67	33 %
6/ 6/68-5/22/69	2/27/68	54.2%
5/27/70-6/2/71	2/28/70	52.2%

Answer 6b if you answered "YES" to Interrogatories 1 and 2 regarding financial statements for the fiscal years 1972 through 1974 and "YES" to Interrogatory No. 3.

Special Interrogatories Submitted to The Jury in the District Court

6b. State the amount, if any, by which each share of Solitron stock was inflated by reason of the financial statements for the fiscal years 1972 through 1974.

28.2¢.

THE FOREGOING ANSWERS TO INTERROGATORIES CONSTITUTE THE UNANIMOUS VERDICT OF ALL OF THE JURORS.

MS. MARIAN BINIMOW

Foreman

Dated: New York, N. Y.,
October 8, 1980.

Excerpts of James Trager's Testimony in the District Court

Trager-direct

[58] DIRECT EXAMINATION By Mr. Rabin:

Q. Mr. Trager, you are a defendant in this action, is that correct? A. Yes.

Q. And subsequent to June of 1962 you were employed by Sternbach & Company as a part-time junior accountant, is that correct? A. Yes.

Q. Sternbach & Company is an accounting firm which is also a defendant in this action; that is correct, isn't it? A. Yes.

Q. And from 1962 to 1964 you worked for Sternbach on part-time basis? A. Yes.

Q. From 1964 to 1966 you worked for them on a full-time basis? A. Yes.

Q. And from 1966 to 1969 you worked for them on a part-time basis again? A. Yes.

Q. You are an accountant, are you not, sir? A. Yes.

* * *

[128] The Court: Overruled on the theory he is a CPA.

Mr. Morrison: I object to the word "claim" and he is not a CPA.

The Court: Objection sustained.

Mr. Rabin: He is an accountant.

The Court: That is not enough. He is a bookkeeper.

Q. Mr. Trager, did you agree with the statement of the Court?

The Court: I understood him to say he was a CPA.

The Witness: No.

The Court: You're not?

The Witness: No, I am not. I do not have a degree in accounting.

The Court: What education do you have professionally?

Excerpts of James Trager's Testimony in the District Court

Trager-direct

The Witness: Two years at Columbia.
The Court: Studying what?
The Witness: Accounting.
The Court: Did you get a degree of any kind from Columbia?
The Witness: No.

• • •

[319] Q. Do you know that the company is pursuing those to this day? A. Yes, I do.
Mr. Morrison: Thank you.
The Court: Mr. Meshel, you may examine the witness.
Mr. Meshel: Thank you.

Trager-cross

CROSS EXAMINATION BY MR. MESHEL:

Q. Mr. Trager, I believe you indicated on your direct examination by plaintiffs' counsel that you were a member of the Sternbach staff from 1964 to 1969; is that correct? A. Yes.
The Court: It won't be necessary to repeat his direct testimony.
Mr. Meshel: I don't intend to, your Honor. I just wanted to give a frame of reference.
Q. Do you recall during the times that you were associated with the Sternbach firm the approximate number of people that were involved from the Sternbach firm with the audit in any particular year of Solitron Devices? A. About a half dozen people, maybe more.

Excerpts of James Trager's Testimony in the District Court

Trager-cross

Q. In your testimony at examination before trial, [320] I submit you said it was as much as twenty people at times. Do you recall that? A. Toward the end, including observation of inventories, yes, it could have been that.

Q. So it was not just you and Mr. Cole but many people in the Sternbach firmed who were involved in the audits of Solitron during the various years you were involved; is that a correct answer? A. Yes.

Q. Do I understand that the times that you were with the Sternbach firm your work was as a staff accountant and you did things like bank reconciliations and procedures such as that? A. Yes.

Q. You were not involved, were you, in any year that you were with Sternbach, in the actural costing of inventory involving the Florida division of Solitron, the actual costing of it? A. That's correct.

Q. You were not? A. I was not involved.

Q. Would you give us an example of the types of things you did do as a staff accountant in addition to bank reconciliations? [321] A. I handled the confirming of accounts receivable, mailing out the confirmations on receivables, payables, insurance schedules, fixed asset additions, vouchering bills to such schedules.

Q. Without trying to minimize what you did, sir, would it be fair to characterize those procedures as the lowest fellow on the rung does that sort of stuff as opposed to the higher echelon supervisory work? A. Yes.

Q. Were there other staff accountants that worked with you? A. Yes.

Excerpts of James Trager's Testimony in the District Court

Trager-cross

Q. Do I understand in an accounting firm there are levels of people, starting at the staff accountant level and working upward? A. Yes, although informal levels in a firm the size of Sternbach.

Q. You start out as a staff accountant and then go to a senior or something equivalent to that? A. Right.

Q. You could be as high as an audit manager—we will explain what that is a little later—is that correct? A. Right

[322] Q. The highest fellow, the fellow responsible, is called the partner in charge; is that correct? A. Yes.

Q. Was Mr. Cole, as far as you know while you were with Sternbach, the partner in charge in each of the fiscal years that you were at Sternbach and were involved in an audit of Solitron Devices? A. Yes.

Q. Was Mr. Cole available during the years you were with Sternbach firm—was he there for consultation and supervision, as far as you knew? A. Yes.

Q. Did he take an active part as far as you know in the audits of Solitron in each of the fiscal years that you were with Sternbach and worked on audits for Solitron? A. Yes, he did.

Q. There has been testimony—

The Court: Whatever there has been, he heard I don't want any introductory comments to questions. Just frame the question. If he does not understand what you are talking about, he will tell you fast enough.

Q. There has been an item marked Plaintiffs' Exhibit 35 in evidence. I hand it to you, Mr. Trager.

* * *

Office - Supreme Court, U.S.
FILED
SEP 10 1982
ALEXANDER L. STEVAS,
CLERK

No. 82-236

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUIS STERNBACH & COMPANY,

Petitioner,

—against—

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, on behalf of themselves and all others similarly situated,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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I. STEPHEN RABIN

In the

Supreme Court of the United States

October Term, 1982

No. 82-236

Louis Sternbach & Company,

Petitioner,

—against—

Howard Sirota, Family Restorations, A Partnership, on behalf of themselves and all others similarly situated,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Alleged Questions Presented for Review

There are no proper questions presented for review here. Sternbach's "questions presented for review" are not fairly reflected by the record.

Sternbach seeks certiorari because of claimed errors by the Court of Appeals in

(i) allegedly applying the doctrine of *respondeat superior*,

(ii) allegedly finding scienter on the basis of "reckless behavior" as opposed to actual knowledge, and

(iii) allegedly inferring fraudulent intent "solely on the basis of claimed inadequate performance of auditing procedures and tests."

As demonstrated below, the Court of Appeals found that there was sufficient evidence to justify the jury's finding of fraud on Sternbach's part. Specifically, (i) the Court of Appeals found that the credibility of Mr. Cole, Sternbach's partner in charge of the Solitron audit, was for the jury to evaluate (*respondeat superior* was an issue neither raised by the parties nor discussed by the courts below), (ii) the jury and the Court of Appeals found that Sternbach's liability was founded on actual knowledge rather than "reckless behavior" and (iii) the Court of Appeals did not find fraudulent intent "solely" on the basis of an inadequate audit but because of a "combination of facts" including knowledge of the fraud on the part of Mr. Cole, and Sternbach's claim that it had performed certain tests and procedures, tests and procedures which perforce would have revealed the fraud.

Statement of the Case

This securities class action was brought on behalf of open market purchasers of stock of Solitron Devices, Inc. Plaintiffs (respondents here) oppose the petition for a writ of certiorari, brought by defendant Sternbach & Co. (petitioner here).

After a two-week trial, the jury found that the defendants had committed fraud. During 1967-70, Solitron announced to the public that its profits for 1967, 1968 and 1970 had increased by leaps and bounds. When the government attempted to recover Solitron's excess profits on government business, pursuant to the Renegotiation Act of 1951, Solitron admitted that its profits had been grossly overstated so that there were no excess profits to recover. The individual defendants, officers and directors of Solitron, actually knew of the income overstatements. Class

members were damaged when they purchased Solitron stock at prices inflated by Solitron's false earnings. (A-46-47).*

Sternbach & Co. certified Solitron's false financial statements for 1967, 1968 and 1970. The jury found that Sternbach had *actual knowledge* of the fraud involved at the time the statements were certified. (A-57, 59-60) This was based upon substantial evidence, including among other things, that Mr. Cole, the Sternbach partner in charge of the Solitron audit, had been directly informed that transactions he classified as sales were actually consignments. It was also based upon Mr. Cole's claim that in fact Solitron's financial statements were accurate in all respects and that Sternbach had performed various auditing procedures and techniques which would have disclosed the overstatements if they existed. The jury resolved the issue of fact as to whether Solitron's financial statements were false and misleading in plaintiffs' favor. (A-71) In view of Sternbach's admission that it performed auditing procedures and techniques which would have disclosed the falsities, the jury was justified in concluding that Sternbach certified Solitron's false figures with actual knowledge of their falsity. (A-59-60)

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* References (A-) are to the appendix annexed to Sternbach's petition.

REASONS WHY THE WRIT SHOULD BE DENIED

POINT I

There Was Sufficient Evidence to Support the Jury's Finding That Sternbach Had Actual Knowledge of the Fraud Involved.

The Court of Appeals reversed the District Court's grant of Sternbach's motion for judgment n.o.v. based on that court's determination that there was insufficient evidence for the jury so to find and reinstated the verdict. Recognizing that whether the evidence was sufficient to support the jury's verdict raises no issues worthy of review by this Court, Sternbach attempts to concoct such issues by citing alleged conflicts involving recklessness and actual intent, *respondeat superior* and controlling persons, and whether an inadequate audit can give rise to an inference of fraud. Whether or not these issues are worthy of review by this Court, such issues do not exist in this case.

(1)

The Court of Appeals held in support of its reversal of the District Court, that there was sufficient evidence to justify the jury's finding that Sternbach had *actual knowledge* of the fraud. The District Court had specifically refused to give a recklessness charge thereby eliminating recklessness as an issue in the case with regard to Sternbach:

> "It is not enough to find that Sternbach acted negligently or falsely or even recklessly . . . you must find that Sternbach acted with *actual knowledge*." (1836a) (emphasis added)*

* References to "a" are to the record.

(ii)

The Court of Appeals held that the credibility of Mr. Cole, the Sternbach partner in charge of the Solitron audit was for the jury to evaluate "in the face of evidence suggesting he was on notice" that Sternbach's certification of Solitron's financial statements were fraudulent. Mr. Cole's knowledge is Sternbach's knowledge; it is not imputed to Sternbach on principles of *respondeat superior*, nor does Sternbach contend otherwise.

Furthermore, Sternbach raised no objection to the District Court's instructions* on Sternbach's knowledge nor did it raise the *respondeat superior* issue in the Court of Appeals. It is presented here for the first time in a desperate effort to gain certiorari.

(iii)

The Court of Appeals held that based on Sternbach's claim to have performed "various costing procedures and

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* The instructions were as follows:

"The second element the plaintiffs must prove is that Louis Sternbach & Company acted intentionally. To hold the accountants liable on this theory, you must find that Sternbach or one of its partners or accountants had actual knowledge of a primary fraud by Solitron. It is not enough to find that Sternbach acted negligently or falsely or even recklessly. To satisfy the second element, you must find that Sternbach acted with actual knowledge. *You will find that Sternbach had knowledge if you find that a responsible person in the company concerned with its work on the Solitron Devices account had such knowledge.*

Now, your common sense will tell you that if the elevator operator or the doorman had such knowledge it would not be imputed to the company because it is not the job of the elevator operator or doorman or the file clerk, for example, to conduct audits or certify financial statements or make representations to the persons who buy and sell securities. *But if a responsible person, such as an accountant or partner, had such knowledge, it would be imputed to the defendant Sternbach.*" (emphasis added) (1836a-1837a)

tests on Solitron's 1967-70 inventory" which would have revealed that the inventory was grossly overstated, the jury was entitled to conclude that Sternbach knew its certification was false. Despite Sternbach's claim at trial that Solitron's financial statements were totally accurate, the jury found those financial statements to be materially false. The jury was then entitled to find that Sternbach knew of the falsities in view of its claimed use of tests and procedures which would have revealed those falsities. It was thus not Sternbach's *inadequate* audit, as asserted in its petition, but rather its claimed adequate audit, which, along with other evidence, supports the jury verdict:

> "The *combination of these facts* leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach knew that its certification of reports overstating inventory was fraudulent." (emphasis added) (A-60)

McLean v. *Alexander*, 599 F.2d 1190 (3rd Cir. 1979) and *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980), *cert. den.*, 499 U.S. 1067 (1980) do not in any way conflict with the decision here. In each of those cases, the court merely held that there was insufficient evidence of scienter to justify imposition of liability. In *McLean*, among other things, confirmation of fifteen out of sixteen questioned transactions were received. *Adams* involved a failure accurately to describe restrictions on dividends. Here, unlike *McLean*, confirmations were *not* received, and here, unlike *Adams*, there was massive overstatement of inventory, coupled with claims by Sternbach that it had employed techniques and procedures which would have disclosed such overstatements.

That different evidence may support different verdicts by different triers of fact hardly means, as Sternbach as-

serts, that there is any conflict among the circuits justifying the grant of certiorari.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit should be denied.

Dated: September 8, 1982

Respectfully submitted,

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